
BUSINESS MANAGEMENT

Executive Manuals 43 and 44

PROVIDING CAPITAL—Being
Executive Manual 43, on Financing a Business, in a Complete Plan of Training and Service for Executive Work

*Investigated, organized, and presented by
the research, consultation, and editorial
staffs of LaSalle Extension University*

Especially acknowledging
the advice and co-operation of

W. P. G. HARDING, Governor
Federal Reserve Bank of Boston
Boston, Massachusetts

R. G. RHETT, President
Peoples National Bank
Charleston, South Carolina

JOHN McHUGH, President
Chase National Bank
New York City

OLIVER J. SANDS, President
American National Bank
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Chicago

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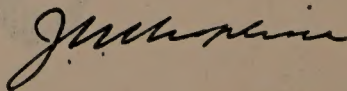
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IRVING R. ALLEN, *Vice President*
H. W. Kastor & Sons Advertising Co.

COL. GEORGE D. BABCOCK, *Manufacturing Executive*
The Holt Manufacturing Co.

WILLIAM R. BASSET, *Chairman of Board*
Miller, Franklin, Basset & Co.
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WILLIAM BETHKE, M.A., *Educational Director*
LaSalle Extension University

JAMES H. BLISS, *Comptroller*
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WM. B. CASTENHOLZ, C.P.A.
Castenholz, Johnson, Block & Rothing
Certified Public Accountants

WILLIAM R. DAWES, *Vice President*
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HARRY ARTHUR HOPF, M.B.A.
H. A. Hopf Company, Management
Engineers, New York and Chicago

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Kendall Mills, Inc.

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Hart Schaffner & Marx, Chicago

JOHN MCHUGH, *President*
Chase National Bank
New York City

HARRISON MCJOHNSTON, M.A.
Director of Business Management Department
LaSalle Extension University

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H. D. ANGER

Elliott, Hume, McKague & Anger
Toronto, Ontario, Canada

CECIL S. ASHDOWN, Vice President
Remington Typewriter Co.

ALEXANDER S. BANKS, C. P. A.
Leslie, Banks & Co.
Certified Public Accountants
New York

K. K. BELL, Vice President and General Manager
Calumet Baking Powder Co.

ERNEST LUDLOW BOGART, Ph.D.
Head of Department of Economics
University of Illinois

HOMER J. BUCKLEY, President
Buckley, Dement & Co.

THEODORE E. BURTON, LL.D.
Former United States Senator

WAYNE E. BUTTERBAUGH, Director of Traffic Instruction
LaSalle Extension University

CHARLES M. CARTWRIGHT, Editor
"The National Underwriter"

FRANK W. DIGNAN, Ph.D.
Correspondence Supervisor
LaSalle Extension University

ARCHER WALL DOUGLAS, formerly Chairman Committee on Statistics
Chamber of Commerce of the U. S.

COLEMAN DUPONT, Capitalist
New York City

DEWITT CARL EGGLESTON, C.P.A. LL.B., Member
Klein, Hinds & Finke, New York

JAMES W. GOOD, Attorney
Good, Childs, Bobb & Wescott
Former Congressman

LOUIS GUENTHER, Editor
"Financial World," New York

ARTHUR B. HALL, A.B.
Hall & Ellis, Real Estate, Chicago

ARTHUR HOLMES, Ph.D., Professor of Psychology
University of Pennsylvania

B. OLNEY HOUGH, formerly Editor
"American Exporter"

PERCY H. JOHNSTON, President
Chemical National Bank, New York

E. H. KASTOR
H. W. Kastor & Sons Advertising Company, Chicago

WM. D. MACCLINTOCK, Professor of English
University of Chicago

T. D. MCGREGOR, Vice President
Edwin Bird Wilson, Inc., Advertising
New York City

PAUL H. NYSTROM, Ph.D., Professor of Marketing
Columbia University
Formerly Director, Associated Merchandising Corporation

ALEXANDER H. REVELL, President
Alexander H. Revell & Company

GEORGE E. ROBERTS, Vice President
National City Bank, New York

MAURICE H. ROBINSON, Ph.D., Professor of Economics
University of Illinois

STANLEY H. ROSE, Vice President
American Safan Corporation
New York City

OLIVER J. SANDS, President
American National Bank, Richmond

CHARLES M. SCHWAB
Bethlehem Steel Corporation

MONROE A. SMITH, Jr., Director of Personnel
U. S. Gypsum Company

H. PARKER WILLIS, Ph.D., Editor
"New York Journal of Commerce"
Formerly Secretary, Federal Reserve Board

JOHN NORTH WILLYS, President
Willys-Overland Company

WALTER F. WYMAN, Sales and Export Manager
The Carter's Ink Company

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PROVIDING CAPITAL

Part I

SELLING THE STOCK

THE first step in financing a new corporation is to determine, after careful and complete investigation, the amount of capital that will be required for starting and developing the business, as explained in Executive Manual 42.

Then comes the question, "How shall we get the stock into the hands of investors? Shall we use advertising, investment bankers, brokers, professional promoters, our own efforts, or other possible means of selling stock in our enterprise?"

A mistake in the plans for selling stock may be very costly, causing much delay and unnecessary expense; it may even frustrate the attempt to secure the necessary capital, even tho the new business is a favorable proposition in the eyes of those who have money to invest in it.

Notwithstanding the fact that the public is nearly always ready to buy up any good stock offer, it is the part of wisdom to be guided by the past experience of successful promoters in making the offer as attractive as possible.

An old and well-established concern may increase its capital with little effort, because it has shown substantial earnings over a period of years and the investor has received a fair return on his investment. In fact, an over-subscription to such an offering is not uncommon. But the prospective earnings of a new company are, at best, somewhat speculative.

The new concern will naturally be subjected to searching scrutiny. The reputation of its promoters will be an important consideration; the extent to which the value of the product has been proved will be investigated; the

prospects of permanent operation at a profit will be tested from every angle. Prospective investors will want to know all the underlying factors which determine the real value of the stock. If any of these factors, such as the extent and character of the market for the product or service to be sold or the experience and ability of the management to turn out and sell the product or service in the face of existing competition, factors that are fundamental to the success of the new business, are not clearly, fully, and favorably presented, investors will be slow to take an interest in the new enterprise.

While many prospective investors wish to investigate every important factor that underlies the probable success or failure of the business, they all depend largely upon the promoters of the business for the facts upon which their judgment is based. Therefore, it is important that—

Careful attention should be given at the start to the securing of confidence in the integrity and reliability of the promoters, who supply the facts concerning the prospects of the new business.

Interesting a Few Investors. Where the amount of capital required is not too large and where the prospects of satisfactory returns are unusually good, it often happens that a small group of investors will wish to keep the whole matter in their own hands. They will not care to offer stock to others outside the group, and the proposition is the more attractive to them because investment in it is confined to a select group of persons who know each other.

Promoters in many cases confine their sales of stock to friends who have money to invest and who have faith in their business ability. Many successful organizations have secured original capital requirements in this way. Certain executives of a successful interurban railway company now operating thru central Illinois were able, largely because of their reputation as efficient managers

of the interurban line, to promote a new enterprise involving \$500,000 among their friends in their local community.

Whether the amount of capital required is large or relatively small, it is often wise to interest a small group of friends first, raise as much as possible of the necessary capital among them, and then, if necessary, formulate plans for selling stock to the public. If some of the first few investors are men of known business ability, their interest in the new company will help greatly in securing the confidence of the general public.

Interesting Many Investors thru Salesmen. In case the stock is not taken up to a sufficient extent by those directly interested in the forming of an enterprise, such as the promoters themselves, their friends, people living in the community, prospective creditors, and the like, then it may be advisable to reach other prospective investors thru salesmen.

Before finally deciding to make use of stock salesmen for raising additional capital, however, it is well to consider this method of selling from all angles.

First of all, the sale of stock to the general public is not an easy undertaking; it requires highly trained salesmen of a type that is somewhat difficult to procure. They must be able to visualize themselves as "pioneers" blazing the trail for a new and worthy addition to industry.

To organize and direct successfully such a sales force calls for a sales manager of exceptional ability. And exceptional ability naturally calls for adequate compensation, both to the sales manager and his men.

From the point of view of the promoters, it is desirable to keep down the cost of raising capital; and the cost of selling stock may be too high if salesmen are employed to call on the general public for subscriptions. As a general rule it may be said that the cost of selling stock thru a special sales force is high. Therefore, this

method is used only when other less expensive methods are not available.

Moreover, the very fact that a special sales force is formed is taken by some prospective investors to mean, on the face of it, that the promoters have been unable to interest friends, bankers, brokers, etc. That is not necessarily the case, of course; but nevertheless many investors shy away from stocks offered by salesmen who directly represent the promoters of a new company.

Altho the use of salesmen is expensive and meets with considerable resistance, yet high-class salesmen can often succeed in interesting many investors who could not be reached in any other way. Unless stock salesmen had been employed, many successful enterprises could never have been launched. It should be remembered that—

The nature of business promotion is such that only the skilled salesman of integrity can be advantageously employed.

This does not mean, however, that salesmen cannot be advantageously employed *indirectly*, as when a stock issue is underwritten by an investment banker or syndicate of banks or brokers who sell the issue thru their own sales forces, as explained later on.

Selling Stock thru Advertising. One reason, no doubt, why so little advertising is used to sell stock in a new company is because a great many newspapers will not accept advertising of any untried proposition which seeks to sell stock to the public.

Practically all advertisements designed to help sell stock are those published by old established concerns which seek additional capital for expansion purposes. And even these advertisements are usually placed, not by the business concern whose stock is being sold, but by an investment house or a bank.

The stock of a well-established concern can be advertised effectively in high-grade newspapers and periodicals, because this advertising is, in itself, evidence of the concern's reliability.

There are many old concerns which have been successful in selling stock directly to the public, such as the New York Telephone Company, Consolidated Gas Company of New York, and the A. T. & T. Company of New York.

Selling Stock thru the Mails. While a new concern may successfully sell its stock direct by mail, this method of selling still tends to cause considerable resistance because it has been used so often by unscrupulous promoters. But "Blue Sky" laws and the efforts of banks, chambers of commerce, and other organizations to stamp out the offering of "gold brick" propositions to investors have served to make the direct-mail method of selling stock more effective.

Where the direct-mail literature is carefully prepared, it is usually found to be worth while. All statements of fact must be rigidly checked for accuracy; the personnel of the new company's organizers and the proposed management must be set forth frankly; and the status of the organization and its purpose must be honestly explained.

Usually the immediate purpose of direct-mail solicitations is to obtain leads in the shape of cards returned which merely ask for additional particulars. Then the information requested is supplied either by mail or by a stock salesman, or by both.

Selling thru Investment Bankers and Brokers. The most common and effective method of selling stock is to place the entire issue in the hands of investment bankers or brokers who specialize in the distribution of securities.

Investment bankers or brokers are constantly in touch with the market demand for different types of stocks and bonds and often a new or a going concern can secure valuable advice from them. They are in a position to advise, for instance, whether or not the time is propitious to bring out a new issue, or whether or not it is to the best interest of the concern to issue bonds rather than stock, etc.

Investment bankers and brokers depend for their sales of securities mainly upon a large clientele of customers whom they have been supplying with securities thruout a long period of harmonious relations. Their business and profits depend entirely upon selling good investments to their customers. Therefore they are not usually interested in speculative issues of small or untried concerns. They seek to eliminate the risk element as far as possible before distributing an issue to their clients. They build up and maintain a reputation for reliable recommendations; and the very fact that a reputable investment banker or broker will handle an issue of stock or bonds gives, to a certain extent, a stamp of approval on that issue.

The banker's or the broker's selling cost is likely to be relatively low, and the issue of stock or bonds is likely to move quickly into the hands of ultimate investors.

As to choosing between selling direct by mail or by personal selling and selling an issue thru a banker or broker, it may be said that—

In general, it is wise to sell an issue of stock or bonds in the way that enables the issuing business to realize the largest possible proceeds from the sale.

But, of course, if the time element is important and a business cannot wait for the capital it is raising to be sold direct to investors, then it may be best to seek an underwriter for the entire issue, even tho less is realized on the issue in this way than could be realized, in time, by selling direct to the ultimate investor.

The Use of Underwriters. A very common method of quickly securing full distribution for a new security issue is thru the use of an underwriter. In many cases, the underwriter is a syndicate composed of several bankers and brokers who take charge of or guarantee the sale of an issue, and sometimes buy the entire issue outright.

In its narrowest sense, the underwriting of an issue of stock is simply guaranteeing or insuring the sale of an

issue of stock or bonds, or a certain portion of it, at not less than a certain price before a designated date. In case the issue of stock or bonds is not sold to investors by that date, the underwriter takes over the unsold portion of it at the stipulated price.

As most of the members of an underwriting syndicate are equipped for selling, the syndicate itself usually takes over the selling function as well as the underwriting function.

To the organizer of the corporation, the chief advantage of underwriting is that the sale of stock is guaranteed. Instead of uncertainty about having the necessary capital to carry on the business, he knows what he can depend on, and can plan more definitely. What he gets for the issue of stock from the underwriters must, of course, be less than the amount the underwriters estimate that they can sell it for by a sufficient margin to give them a satisfactory profit.

As a rule, only the larger issues of stocks are underwritten. An underwriting syndicate usually does not find it profitable to make the thoro investigation necessary to determine a corporation's standing and prospects unless the issue is at least \$250,000.

Other Ways of Selling Stock. Occasionally the organizer of a corporation may be able to interest some business executive or financier to take the stock either for resale as a speculation or for holding as an investment.

There are numerous cases on record where engineering companies have become stockholders in various corporations. The engineering company would, for instance, take stock in payment for its services in building the plant and then either hold the stock or sell it out later on when its market value had been definitely established.

It should not be disappointing to the promoters of a small company to find the stock-selling problem a difficult one. Experience shows that most new ventures,

unless spectacular in nature, like oil or mining propositions, have had to grope slowly from the bottom. Each step of progress, as well as each claim made for the future, has to be proved before outsiders are willing to invest their funds for profit.

If we look back over the successes of some of the nation's greatest corporations, we see that at the beginning they encountered the hardest kind of struggle to get people to believe in the financial worth of the undertaking. Striking examples are found in the early years of the International Harvester, the Willys-Overland Company, and the Ford Motor Company.

SELLING METHODS COMPARED

Admittedly, it is impossible here to specify the exact type of stock-selling arrangement that a new concern ought to make. It is possible simply to indicate the experiences of others and to point out the favorable and unfavorable features of the various plans.

As to expense, investigation indicates that there is usually not much difference between direct selling and selling thru other agencies. But direct selling, as previously suggested, may take more time than to sell thru established agencies that are well equipped for rapidly distributing an issue of stock or bonds.

On all important points, it is wise, as a rule, to confer not only with a banker but with a reputable investment broker and with a lawyer as well. Many banks have securities departments where valuable suggestions on how to proceed can be obtained. Provision must be made to comply with all the laws before the public is approached in any way.

Even tho the well-established channels of distribution for securities are keyed up to meet, primarily, the requirements of the large and long-established business enterprise, still the small and untried venture has ample opportunity.

Faith in the ultimate success of the business, intelligence, skill, and persistence are the real fundamental requirements necessary to raise capital for the worthy new venture.

When Established Concerns Sell Stock. After a concern has proved itself and then desires to expand, it is much easier to sell additional securities, either direct or thru an investment company. The problem is then comparatively simple, for the securities of a successful well-established enterprise usually enjoy strong public demand. Reputable investment houses are looking for opportunities of this kind and are able to assume all the burden of raising additional capital.

The small company should remember, however, that most of the large nationally known enterprises of to-day started with similar handicaps.

It is not difficulties and handicaps which decide the fate of a new venture; it is the fortitude and perseverance with which the difficulties are faced.

The conditions in a new or growing business must be analyzed and weighed, and the stock selling handled wisely on the basis considered as most applicable to the specific need. Wrong methods once tried make subsequent efforts more difficult.

If the new or young undertaking is meritorious and good business judgment has been used in planning its development, sufficient funds for each step should ordinarily be forthcoming without great difficulty—for the huge mass of funds available for investment is constantly flowing into lines of business, including new enterprises both large and small, where the opportunity for profit in relation to safety is most attractive.

In case it is found very difficult to attract capital, then it may well be wise to concentrate on the problem of making the business itself the kind that is more attractive to capital, rather than attempting to find or devise a stock-selling method good enough to sell the stock of an

unattractive enterprise. This is application of the principle, previously stated in the section on sales management, which tells us to give due attention to the quality of the thing sold as well as to the methods employed in selling it. Application of that principle underlies success in selling stock as well as in selling automobiles.

Thus far we have been concerned mainly with the sale of stock as the means of financing a business, especially a new one; that is, in distributing ownership shares in a corporation. In Part II we shall extend our analysis to include the uses of bonds as a means of borrowing money needed in financing a business.

PROVIDING CAPITAL

Part II

THE USE OF BONDS IN FINANCING

WHEN a growing concern is faced with the problem of securing additional capital for investment in new buildings, machinery, equipment, and other types of fixed assets, it must, of course, determine the best method of obtaining that capital. Surplus earnings are often insufficient to take care of these growing needs.

To meet these needs, the financial manager faces two alternatives. He may either increase the capital stock of the business thru the sale of additional stock, or he may borrow the amount necessary to meet requirements, as by an issue of bonds.

His choice between issuing stock or bonds will depend upon a careful consideration of the financial condition of his concern and upon a study of money and business conditions in general.

The method employed to raise capital should be the one which will accomplish the purpose intended and in the long run enable the owners of a concern to obtain the greatest returns.

It is not always possible or desirable to increase the amount of capital stock outstanding. If the nature of the business and its earnings permit long-term financing, there may be an opportunity to increase considerably the profits for the existing stockholders by selling bonds instead of stock.

A hydraulic power plant, capitalized at \$3,000,000, was able to pay 8 per cent regular dividends on its common stock. It had no bonded indebtedness. New equipment was required involving an expenditure of about \$1,000,000. The directors believed that the additional equipment would increase the earning power enough to enable

them to pay 8 per cent dividends upon \$4,000,000 of stock.

Dividends at 8 per cent on \$4,000,000 would total \$320,000, while dividends at 8 per cent on \$3,000,000 were only \$240,000, a difference of \$80,000. The directors found that they could float a million-dollar bond issue secured by a mortgage on the combined properties, at $5\frac{1}{2}$ per cent; so they decided on a bond issue instead of an issue of new stock. The interest charge on this bond issue amounted to \$55,000 a year, whereas the 8 per cent dividend would have amounted to \$80,000, as above pointed out. Thus the stockholders gained \$25,000 a year—and there was, of course, the expense of floating the bond issue as compared with the expense of distributing a new stock issue to be considered.

The Mortgage Behind Bonds. Wherever recourse may be had to pledging some of the real estate, buildings, equipment, or other permanent assets of the company under a mortgage as security for a long-term loan, an issue of long-term bonds often affords the stockholders of a business an opportunity to secure additional capital for investment in additional land, buildings, or equipment, and thereby adds materially to the annual earnings of their stock holdings, as in the case just mentioned.

The mortgage secured by real estate is one of the oldest and best-known types of security. It is so well protected by law that it makes the best of security for investors, and is consequently popular with savings banks, trustees, and other conservative investors.

While in some states the title to specific property technically passes to the lender under a mortgage loan, still in practice a mortgage is regarded as a lien, and leaves the borrower in undisputed possession of the pledged property so long as the interest is paid regularly, the property kept intact, and other essential terms of the mortgage agreement are complied with.

This practice of treating the mortgage as a lien is important in financing, since it enables a business concern to borrow thru a mortgage on part or all of its property without losing control of the operation and profits of the business, so long as all payments of interest and principal when due and other conditions of the mortgage are complied with promptly.

But the use of the simple mortgage is restricted to the borrowing of comparatively small sums, since it is impracticable to split the security up among a number of lenders or investors, and only in rare instances is a single individual or banker able or willing to lend the large sums frequently required by business concerns.

This situation has given rise to the introduction of a third person, the trustee, into the borrowing transaction; and this arrangement makes possible the issue and sale of bonds. The bonds are the means of dividing up the loan among a large number of investors for all of whom the trustee holds the property which has been put up as security under what is called a trust deed.

In seeking the services of a trustee (usually a bank or trust company serves as trustee) the borrowing concern must expect to undergo a very searching examination of its affairs, for no reputable trustee will be found willing to undertake the responsibilities of the position without insisting upon such an examination.

The Contents of the Indenture. In general practice, the deed of trust or trust deed, which in effect is a mortgage conveying the property to a trustee instead of direct to the investors, and all the particulars connected with the bond issue are contained in one and the same instrument called the indenture.

The indenture outlining the conditions and terms of a bond issue must, of course, be very carefully and completely drawn. In the case of large bond issues, the indenture is usually a lengthy document. An illustration

of the contents of an indenture is the agreement entered into by the Hudson & Manhattan Railroad Company with the Guaranty Trust Company of New York as trustee for an issue of bonds. This document runs into well over one hundred pages of printed matter. An idea of the nature of the subjects covered in it may be gained from the following heads:

1. Parties.
2. Recitals of:
 - (a) Purpose of the issue.
 - (b) Nature and amount of the issue.
 - (c) Authority given by the stockholders and directors.
 - (d) General nature of the security (specified in detail later in the instrument).
3. Form for coupon bonds and coupons.
4. Form for registered bonds.
5. Form of trustee's certificates of validity of bonds.
6. Granting clause.
7. Detailed description of properties mortgaged.
8. Habendum clause.
9. Declaration of trust.
10. Detailed specifications for the execution, issue, and registration of bonds.
11. Covenant as to payment of principal and interest.
12. Particular covenants of the company, as to:
 - (a) Payment of underlying obligations.
 - (b) Maintenance of corporate existence.
 - (c) Extension, renewal, or discharge of underlying obligations.
 - (d) Priority of lien.
 - (e) Maintenance and insurance of properties.
13. Provision for retention of possession.
14. Detailed provisions for return of ownership on repayment by the borrower.
15. Provisions in case of failure to pay interest.
16. Privileges of the trustee.
17. Provisions for redemption of bonds.
18. Miscellaneous terms.
19. Signatures and corporate seals of the parties.

While the detailed provisions of one such indenture usually differ materially from those of another, the subjects covered in the list above give a very good idea of the general provisions common to such instruments.

Open and Closed Mortgages. One of the important things that the purchaser of bonds secured by a mortgage wants to be sure of is that the value of the property mortgaged will be maintained during the life of the loan. He wants to know whether the mortgage is "open" or "closed"; that is, whether or not further loans can be made, or bonds issued, by giving a first lien on the same pledged property.

Naturally, if the mortgage is open to further loans on the same security, this tends to weaken the security from the bondholder's point of view; altho limited "open end" mortgages are often used to leave a way open for meeting the expanding financial requirements of the business. A limited open-end mortgage may, for example, make possible further issues up to a certain percentage of any improvements made on the property.

A closed mortgage sets a definite limit to the amount of the loan that the borrower can get on the basis of the same security. The difficulties which this limitation places in the way of the borrower can be avoided in many cases by making the original bond issue considerably larger than is immediately required.

The chief requirement of security back of a bond issue is that the property pledged shall be of definite and permanent value and be always salable at a price sufficient to prevent any loss to the bondholders in the event of default on any payments of interest and principal when due.

Real property is generally best suited to meet this requirement, altho certain types of personal property, such as stocks and bonds, machinery and equipment, may also offer security of the kind that is always salable at a price

sufficient to prevent loss, particularly when put up as security on relatively short-term bonds.

The General Classes of Bonds. A bond is simply an interest-bearing debt certificate. These certificates have become generally standardized into two general types:

1. The registered bond.
2. The coupon bond.

A bond may be registered either as to principal and interest or as to principal alone. When registered, the name of the owner of the bond appears on the books of the corporation and any transfers of ownership must be recorded in those books. Interest, when registered, is usually paid by check to the person in whose name the bond is registered.

Coupon bonds are transferable from holder to holder usually without registry. Interest-bearing coupons are attached to the bonds indicating the amount and the date when interest is payable. The holder of the bond simply clips the coupons and deposits them in his bank for collection.

Coupon bonds are usually issued in denominations of \$100, \$500, as well as \$1,000, while registered bonds are usually issued only in the higher denominations. Coupon bonds have, on rare occasions, been issued in denominations under \$100 for popular distribution.

What Shall Be the Term of the Bond? The corporation confronted with the problem of issuing bonds needs to determine carefully how long the loan shall stand before the amount borrowed is to be repaid to the investors.

All bonds issued against pledged property are affected by the life of that property. In the case of "wasting assets," such as mines, sand pits, and quarries, short-term issues are common, and special provisions for protecting the security are employed, as by redeeming a certain portion of the outstanding bonds from year to year and thus gradually cutting down the amount of the loan, so that

the relation between the outstanding bonds and the value of the assets securing them remains unchanged.

Where personal property and equipment are pledged, such as freight cars and engines on railroads, obviously the term should not be longer than the productive life of the property pledged. But where real estate, buildings, and other property that is not likely to undergo a depreciation in value are pledged, the life of the bond may be 50 or even 100 years. Furthermore, the term or life of a bond issue is also vitally affected by—

(a) The money market at the time.

(b) The credit condition of the company.

When money rates in general are high, business concerns have to offer relatively high interest in order to attract additional capital, and they therefore favor short-term notes or bonds at such times. Then later on, when interest rates are lower, the short-term notes can be taken up with the proceeds from an issue of long-term bonds which can then be floated at a lower rate of interest. This often results in saving many thousands of dollars a year over a long term of years.

How the credit condition of a company influences terms of issue is illustrated by the action of a certain food-manufacturing corporation in the earlier years of its life when it had not fully established its permanency and earning capacity in the financial markets. It became necessary to expand the plant. To finance the purchase of the property and the new building, it was necessary to issue five-year, high-interest bonds. At the maturity of these bonds, however, the company had so well established itself as a permanent business and with such a good general credit rating that it was then able to refund the five-year bonds (that is, replace them) with other bonds of longer term and at a lower rate of interest.

Fixing the Rate of Interest. Provisions regarding interest payments concern the rate of interest that the bonds shall yield and the dates and place of payment.

The fixing of interest rates is a complex problem in which such questions as money conditions, the financial strength of the company, the size of the issue, the character of the bond, the probable popularity of the issue, the nature of the security, and many other factors need to be considered. The interest rates are usually established in conference with the financial institution which is to handle the sale of the issue.

The price of bonds as first offered to the public and the interest rate are fixed at the points which are most favorable to the borrower and at the same time insure satisfactory sale of the bonds to the public.

Interest payments on bonds are almost always made semiannually. The months of the year in which interest payments are to be made should be chosen with reference to any seasonal changes in the monetary requirements of the business. If, for example, a business has an unusually large volume of bills and accounts payable in the spring and fall of the year, then the January 1 and July 1 interest dates would normally be more suitable than March 1 and September 1.

The place of payment must also be definitely designated. Usually a bank or trust company in one of the larger towns is designated as the place of payment.

Determining the Class of Bond to Use. The fact that so many different kinds of security are pledged to guarantee the payments of interest and principal on bonds is the chief reason why there are so many different classes or kinds of bonds; which offer varying degrees of safety to investors.

The stronger the security, the lower is the interest rate required to make a bond issue attractive to investors.

For the average business man, the most useful classification of the general types of bonds is that founded on the kind of security behind them. On this basis of classification, the most common kinds of bonds used in

financing a business may be divided into two general classes:

1. Those secured by specific assets, such as land, buildings, and securities.
2. Those secured only by the promise of repayment of principal and interest of the concern issuing them; that is, by the general credit of the company (usually called "debenture bonds" in the United States; but also including income bonds, explained later on).

The types of bonds commonly found under these two general classes are as follows:

1. Bonds secured by specific property:
 - (a) Mortgage bonds.
 - (b) Guaranteed bonds.
 - (c) Collateral trust bonds.
 - (d) Equipment trust bonds and bonds secured by lease.
2. Bonds not secured by specific property:
 - (a) Debentures.
 - (b) Convertible debentures.
 - (c) Income bonds.

While there are numerous other types of bonds offered, each of them will be found to correspond essentially to one of the seven types listed above.

Because of the many legal and financial technicalities involved in a bond issue, it is always wise to seek the advice of a lawyer, a banker, and a bond expert when planning to raise money thru the sale of bonds. But it is well for every executive, either as a borrower or as a lender, to understand the main features of different types of bonds.

Mortgage Bonds. As a general proposition, the type of bond issue most popular with investors is one secured by a first mortgage. In some cases, bonds are issued under a second mortgage, or even a third or a fourth mortgage. However, the second or other so-called "junior" mortgages, altho they may yield a high rate of interest, are not as salable as first-mortgage bonds, because of the greater security attaching to the latter. But the higher

rate of interest usually offered on a second-mortgage issue serves to counteract the effect on investors of any additional risk involved.

Notwithstanding the general acceptability of mortgage bonds, the condition of the investment market should be studied carefully when a bond issue is contemplated.

The type of security pledged and the interest rate must be carefully adjusted to the current demands of investors if the whole issue is to be sold at top prices.

A manufacturing concern decided to borrow \$500,000 on 20-year bonds bearing 5 per cent interest, secured by a first mortgage on its real estate and buildings. The security was excellent, but investors paid little attention to the issue. They were, at the time, more interested in high dividend and interest paying securities. The result was that this bond issue had to be sold at "81"; that is, each \$1,000 bond brought in only \$810. Thus this concern found itself paying 5 per cent on \$500,000 for the use of \$405,000; and it would be obliged to pay back \$500,000 after 20 years, or \$95,000 more than it borrowed. Thus the use of \$405,000 was costing it (including the additional \$95,000) almost \$30,000 a year, or well over 7 per cent; whereas it could have realized closer to \$500,000 on the issue instead of \$405,000 had it offered bonds bearing 6 per cent interest instead of 5 per cent. And the use of the larger amount realized on the sale of the bonds would not have cost any more per year.

Guaranteed Bonds. Sometimes a large corporation which owns a number of subsidiary concerns cannot float a new bond issue because of the limitations of the mortgage under which a former issue was sold.

In this case it may be possible to sell bonds of the subsidiary companies, secured by their property and guaranteed by the better-known parent organization. Such are guaranteed bonds.

The favor with which investors regard guaranteed bonds will depend partly upon the completeness of

the guaranty, and partly upon the reputation for strength possessed by the guarantor.

Collateral Trust Bonds. A concern owning a considerable amount of stocks and bonds of other companies may use these securities as collateral for a mortgage under which its own bonds may be sold. Such bonds, secured by other stocks or bonds, are called collateral trust bonds; they have been used to a considerable extent in financing American railroads and holding companies. Holding companies are corporations which purchase and hold an ownership interest in other companies.

Where the borrowing concern is not dependent upon the dividends from the pledged securities for payment of interest on the bond issue, investors will be willing, as a rule, to pay a higher price for these collateral trust bonds than would be the case where the borrower relies largely upon the return from his stocks and bonds pledged as collateral to pay the interest. In the latter case, the price of the collateral trust bonds is likely to fluctuate with the market price of the pledged securities.

Equipment Trust Certificates. New railroad cars, engines, and other railroad equipment are sometimes purchased by a syndicate and leased to the railroads. The railroad equipment is then pledged as security—thru the assignment of the lease to a trustee—for an issue of car or equipment trust certificates to be sold to the public.

A definite portion of the issue of equipment trust certificates matures and is paid off each year, so that the outstanding obligation is reduced from year to year as the value of the equipment pledged as security depreciates in value. The decrease in outstanding certificates is faster than the actual rate of depreciation in the market value of the equipment. Thus, because of the excellent security, these certificates are popular with investors.

Leases, installment contracts, and mortgages held by concerns selling merchandise on the installment plan are sometimes pledged as security for a note issue. This

method of financing has developed in recent years in connection with such lines of merchandise as automobiles, talking machines, pianos, washing machines, and furniture. Several financial houses now specialize in acting as trustees and in certifying note issues secured by the customer obligations to concerns in these lines.

Debenture Bonds. A strong concern may employ its general credit standing as the only security for a relatively long-term bond issue. Bonds secured by the general credit of a company are, in the United States, called "debenture bonds." They are unsecured promises to pay, which have prior claim on income over dividends on stock. They are particularly useful in cases where a company has a good steady income, but has little in the way of tangible property which could be put up as security for a mortgage bond issue, as in the case of some publishing companies which own valuable copyrights but very little physical property. Railroads have also used them. But debenture bonds cannot ordinarily be used by small companies or by large companies whose credit standing is not excellent.

Interest on these bonds, as on most other bonds, is cumulative. These bonds also usually permit drastic action to compel payment of interest in the event of a default. The relative simplicity of issuing debenture bonds is an advantage to the company which is strong enough as to the steadiness and size of its net income to make its unsecured promise to pay attractive to investors.

Convertible Debenture Bonds. As a means of reaching bond buyers who desire a speculative opportunity to share in the future profits of the business, debenture bonds—and secured bonds—are sometimes issued with the privilege of converting them into the stock of the company at a fixed price. This conversion privilege may expire at maturity or on a definite date before the bonds mature.

From the point of view of the borrower, the sale of such convertible bonds amounts to a deferred sale of stock. Frequently these bonds can be sold at a much higher price than the stock would bring at the time of issuing the bonds. That is the advantage to the borrower. But the stock may rise in price above the price fixed at which the bonds are convertible into the stock. That is the speculative advantage to buyers of convertible bonds.

The conversion privilege is not confined to debenture bonds, but is sometimes a feature of other types of bond issues. Thus, the circular announcing the issue of \$2,000,000 worth of ten-year 7 per cent bonds by one manufacturing company, dated April 1, 1925, and secured by a closed mortgage on all the property of the company, provided that "the bonds are convertible after April 1, 1927, and until maturity, into 8 per cent cumulative preferred stock of the company, par for par; or, when accompanied by warrants, into common stock at \$40 a share at any time after April 1, 1927, and to and including April 1, 1930, and thereafter at \$50 a share," etc.

Income Bonds. The income bond has been used very little in recent years, because it is not popular with investors in the United States. It pledges the payment of interest only when, in the judgment of the management of the borrowing concern, the income earned is sufficient to warrant payment, altho, like any other bond, the principal is payable at a definite date. Obviously, such bonds are not in the least attractive to many investors. It is mostly thru necessity due to forced reorganization that income bonds are issued and are accepted in exchange for other securities of the issuing company.

Consider the Investor. It is clear from what has been said that financial management must continually consider the preference of investors when planning a bond issue.

The purpose of a bond issue is to purchase the use of capital at the lowest cost—which does not necessarily mean the lowest interest rate.

The bonds as issued must be attractive to investors—sufficiently attractive to command a ready market. This attraction may lie in the security of principal and the regularity of income, in which case most investors will accept a low interest rate. As the security of principal is weakened, the interest return demanded by purchasers will increase. Special features such as the conversion privilege should have careful consideration as a possible means of securing the required capital at the lowest cost at the time of a bond issue, even tho the exercise of the conversion privilege may later on give the investor a much greater return on his money; for then, later on, the issuing company will probably be well able to pay him the greater return.

PROVISION FOR REPAYMENT

Care must also be taken to provide for ultimate refunding or repayment of the funds borrowed by a bond issue. In case it is the intention of the borrowing concern to retire the bonds at maturity, it is desirable to accumulate the necessary funds by establishing a sinking fund; that is, by setting aside each year out of net income an amount which will be sufficient to retire the bond issue at maturity.

Many bond issues, however, are refunded at maturity by means of a new issue of bonds, stock, or short-term notes. Which of these three types of security can be used to best advantage will be determined largely by the trend of conditions prevailing in the investment market at the time of maturity.

In the case of bonds secured by buildings, equipment, and other property the value of which decreases with the passing of time, the serial form of paying off bonds is usually adopted; that is, a certain number of bonds

mature annually and are retired by repaying the principal; thus gradually the size of the outstanding bond issue is lessened as the security behind the remaining outstanding bonds depreciates in value.

It is evident that the amounts and dates of maturity on serial bonds should be planned so that large payments will not have to be made at times when other heavy financial obligations must be met.

The Increased Popularity of Bonds. While in past years the use of bonds in financing was confined chiefly to the national, state, and municipal governments; to railroads and other public service corporations; and to some of the larger industries, the tendency in recent years is toward the use of the bond issue as a means of financing medium-sized business concerns as well.

The reason for this is, chiefly, the greater familiarity of the public with bonds as investments. The War, with its issues of Liberty bonds, gave an enormous impetus to this movement of educating the public and enlarging the investment market. The probability seems to be that business will in the future find more general use for bond issues as a means of borrowing capital.

To reach the small investor, it is advisable to make the denomination of bonds as low as possible. The so-called "baby bond," having a par value of \$100 or \$50, can be more easily distributed among a large number of purchasers. However, the selling cost is usually greater than in the marketing of bonds of higher denominations.

Issues of bonds and stocks are usually designed to meet the more permanent financial needs of a business. There are also other kinds of financial needs which we shall consider in Part III of this manual.

PROVIDING CAPITAL

Part III

HOW TO BORROW PROFITABLY

IT IS now clear that there are, in general, two kinds of capital to be provided for a business and two ways of providing it.

Capital must be provided for the purchase of property, such as land, buildings, and equipment, called "fixed capital assets"; and capital must be provided for meeting all the current expenses of operating the business, which capital is called "working capital."

Both fixed capital and working capital may be provided by the sale of an ownership interest in the business, as when a new partner is taken into a partnership or when a new issue of the stock of a corporation is sold. Both fixed and working capital may also be provided by borrowing.

Relatively long-term loans are negotiated in providing fixed capital, as by a bond issue; while a short-term loan is negotiated in providing working capital, as when a banker discounts the promissory note of a business with an established credit standing and thus provides funds with which the business can meet its current bills or notes payable. Then, in sixty or ninety days, the business can pay off the note with the proceeds of its collections that come in during the term of the note.

The Problem of Short-Term Borrowing. Parts I and II of this executive manual dealt mainly with long-term borrowing and with the sale of an ownership interest as a means of providing capital primarily for the purchase of fixed capital assets. This final study of the problem of providing capital will deal mainly with short-term borrowing as a means of providing adequate work-

ing capital, altho some of the principles here presented apply to long as well as to short term loans.

The problem of borrowing, in general, resolves itself into several basic questions, as follows:

When shall a loan be made?

How long shall the loan run before it matures?

How much shall be borrowed?

Where shall the loan be made?

The last of those four questions brings up the problem of choosing a banker and how to deal with the bank; for, usually, short-term loans of funds to be used as working capital are made at a bank. Therefore, this problem of choosing a bank and of establishing the right relations with the bank chosen will be covered in this part of our training for executive work.

When to Borrow. To borrow or not to borrow is sometimes a puzzling question. It often pays to borrow when borrowing is not absolutely necessary, as when a business borrows in order to take advantage of cash discounts and build up or keep up its credit standing among those from whom it buys materials and supplies.

In general, an efficient business executive decides to borrow capital only when it is necessary or advisable in order to increase net earnings. In short, he borrows whenever it pays to borrow. But sometimes it is difficult to tell whether or not it will pay to borrow. The temporary need for additional working capital may be caused by inefficiency in some department as when goods are sold on credit terms that are too long or too loose or when inefficient collection methods are employed. In that case, of course, it pays to avoid borrowing by watching credit extensions more closely or by improvements in collection methods.

Whenever the "necessity" of borrowing can be traced to definite causes that are related to inefficiency in operating the business, those causes can and should be removed.

Borrowing serves no good purpose unless it enables the borrower to make a greater profit than he could make were he not to borrow. Profitable borrowing is linked closely with good management in all departments of a business. If borrowing is resorted to for financing expansion of sales and output, the added selling expense and the cost of additional equipment and labor, including the expense of "breaking in" new employes; of an increase in the cost of supervising labor; and so on—all added expenses in relation to increased income from the larger sales volume—must be carefully considered. The permanence of the larger sales volume must be assured.

Thus to determine when borrowing can be done profitably requires sound analysis and judgment. The mere fact that a loan is obtainable at a reasonable price does not mean that it is wise to borrow. The general rule, as above stated, is to borrow only when it pays to borrow, and—

It pays to borrow only when the use of the funds borrowed results in a gain that exceeds the cost of borrowing.

There is no stigma attached to borrowing from a bank or elsewhere for the purpose of securing a greater profit from the operation of a business. The chief function of the modern bank is to help finance successful business operations.

While banks have helped pull many business concerns thru financial difficulties, a banker is seldom disposed to help a business that is being or has been mismanaged. If he does help under this condition, his service is contingent upon correction of the inefficiency of the management of the business. No business can expect to have the enthusiastic co-operation of a banker if it is managed in slipshod manner.

We cannot too greatly emphasize the fact that—

A prime requisite of profitable borrowing is that the borrower's business organization be efficiently managed.

Factors Affecting the Profitableness of Borrowing. Analysis of the factors that affect the profitableness of borrowing brings out consideration of—

1. The time of borrowing.
2. The location of the borrower.
3. The borrower's type of business.
4. The specific use of the funds to be borrowed.
5. The risk involved in making the loan, as affected by
 - (a) The security offered, if any.
 - (b) The period of the loan.

Each of the above factors has some effect upon the cost of borrowed funds. If the time when the loan is made is not favorable, if funds available to borrowers at the time are relatively scarce in relation to the general demand for funds, a high price will have to be paid—unless other factors are sufficiently favorable to counteract the competition of other borrowers for available funds.

It is sometimes possible during times when money is cheap to make loans of the longer term kind in anticipation of the need for funds later on when interest rates and discounts will be higher. Many concerns make a practice of borrowing in quiet times for the purpose of making improvements and for other special activities, getting the work done at relatively low cost, and then paying off the loan later on during better times when profits are better—and when, thru rising prices, the value of a dollar is lower, as explained in Executive Manual 4.

Especially in negotiating a long-term loan of a fairly large amount, it is necessary to guard against paying a high rate of interest over the entire period of the loan. If possible, short-term notes should be issued instead, to be taken up and "refunded" at a lower rate of interest when the rate declines. If bonds are issued, the privi-

lege to call them in at a certain price should be retained by the borrower.

The Effect of Location. Location has a direct influence on the interest rate. For instance, the local banks in a small town may be charging a higher rate of interest than the rate charged on similar loans in a large commercial center. It may therefore be advisable, where possible (if the business is large enough to warrant it), to establish a connection with a large city bank.

But there are many obvious practical advantages in dealing with a bank that is close at hand. This is particularly true in the case of a small borrower. The convenience of borrowing at a small local bank often more than offsets the difference in rates.

Generally speaking, the rates of interest in the East run less than rates in the far West and South. The Middle-West rates are usually about the same as those in the East, while in the far North and Northwest the rates are higher. For this reason the matter of location of the borrower and the source of the loan have to be considered, altho usually the interest rate will be found to conform satisfactorily with business conditions in each particular section of the country.

An executive should be hesitant about outside borrowing unless conditions make it necessary or are distinctly favorable for it.

It is difficult for a small business to borrow directly from far-away bankers and it is seldom advisable for a large business to go outside for short-term loans unless a decided advantage is to be gained by doing so. A local bank can render so many valuable services in addition to loaning money that a business man can well afford to be careful that he does not jeopardize his standing with the local banker.

The Type of Business. Loans to some kinds of business naturally entail more risk than do loans to other kinds

of business, and the rate asked for loans will vary accordingly. If the product or stock of a business has a variable or uncertain demand, is highly seasonal, or is likely to deteriorate in value quickly, a higher rate of interest is asked than in the case of a business dealing in staple products which do not depreciate and are always in demand. The risk to the lender is greater in one case than in the other, and interest is, in part, payment for risk incurred by the banker.

Comparing women's apparel and soap, for example, the former quickly loses its chance to bring a good price, while the latter sells always for practically the same; in fact, age improves the quality of soap.

Banks and other lending agencies consider the risk involved. Any improvement in a business, such as that of broadening and strengthening the market for its products or that of changing the nature of the packing of a product so that it is less susceptible to deterioration, which cuts down the risk of loss on the part of those who lend money to the business, is more attractive to these lenders, and therefore is an inducement for them to lend it money on more favorable terms.

Every type of business can reduce its cost of borrowed funds by reducing its risk of loss.

The Specific Purpose of the Loan. The specific cause of the need for funds is an influence on the price that will have to be paid for a loan.

Bankers justly feel that they have the right to know what the money they lend is to be used for.

This is true because the use made of money borrowed may have much to do with the degree of risk involved in making the loan. If the loan is to be used for taking advantage of cash discounts on purchases, the risk to the lender is likely to be less than if the borrowed money is to be used in paying off overdue accounts or in purchasing materials or stock which may or may not be

converted into sales and collections by the time the loan is to be repaid.

Ordinarily the applicant for a loan will find his chances for getting the money he wishes greater if he tells voluntarily at the outset why he is borrowing.

The Risk Factor. The risk factor was necessarily mentioned in preceding considerations. It is also related to the length of time the loan runs and to the kind of security pledged to guarantee repayment.

Money desired for a long period may be had only at a higher rate of interest than money borrowed for a shorter period, because it is thought that the longer the loan runs, the greater is the risk to the lender. If so, it may be advisable, if possible, to negotiate a series of short-term loans rather than one long-term loan; especially so when interest rates in general are tending downward.

But, of course, the nature of the security offered by the borrower may, whether the loan is relatively long or short, be such as to hold down the rate of interest. Loans secured by pledging high-class securities, such as Liberty or other Government bonds, are often made at a very low rate of interest as compared with loans made with nothing but the general credit of the borrower as security. Whenever good security is available to serve as collateral for a loan, it is usually wise so to use it, for—

Sound collateral, by tending to minimize the element of risk involved in a loan, tends also to lower the cost of borrowing.

If, however, a reaction in general business conditions may come, when bankers in general pare down their loans and require greater security, it is wise to keep available collateral for loans on tap in case of emergency rather than use it for the purpose of securing more favorable terms.

CHOOSING A BANK

In every case, a borrower does well to give careful consideration to the source from which he is to borrow. This means, primarily, careful choice of a banker.

A business man chooses a bank, not primarily as a place to deposit his funds, but as a source of borrowing to meet his financial needs.

Almost any bank these days is safe enough to trust with deposits, but not all of them can be depended on to lend the money that may be needed in carrying on a business. In selecting a bank, the organization and personnel of the different available banks should be considered; also the class of business that they are accustomed to and are prepared to handle, the character and reputation of the directors, the business ability of the officials, and so on.

To analyze these qualifications adequately, it is necessary to have a fair knowledge of the different types of banks and of the significance of the various kinds of services which they are capable of rendering.

The average business concern needs a bank for one or more of the following services:

1. To lend it money and discount its notes and commercial paper.
2. To supply a commercial checking account.
3. To safeguard funds and savings.
4. For business counsel, and advice on investments.
5. To serve as trustee.

A business concern will not necessarily need a banker who offers all these services; but the bank chosen should offer all banking services that are likely to be needed.

The Lending of Money. It is necessary to know whether or not your bank is large enough to supply all the funds needed.

National banks are forbidden by law to lend to any single borrower an amount that exceeds 10 per cent of their (the banks') capital stock and surplus; and nearly

all state banks are now bound by definite limitations. The large borrower may be unable to obtain adequate loans from his local bank with its relatively small capital and surplus, and therefore be compelled to go outside for his financing. Some business houses in small communities have additional banking connections in larger cities.

If your loan requirements are to be large, it is best to choose the local bank whose capital and surplus are large enough to accommodate your requirements, or a local bank which has other banking connections to supplement its lending power to you, if necessary.

The business concern which receives payment for its product or service in the form of notes of its customers or in the form of trade acceptances, will desire, to some extent at least, to discount this commercial paper at its bank. Where this is done, it is best to deal with a bank which is thoroly familiar with the commercial paper in that particular line of business. National banks and state banks which are member banks in the Federal Reserve System have an advantage in discounting many forms of bills thru their rediscounting privilege at the Federal Reserve Banks.

Carrying Your Checking Account. There are several points to be considered in relation to the checking-account service which a bank renders, such as the business standing of the bank, the balance of deposits required, the location of the bank, its financial strength, and so on.

The business standing of a bank can be determined by knowing something of its depositors. If a bank has a good standing in the community, it has undoubtedly acquired a large group of satisfied customers who are willing to recommend the bank to others.

Merchants and business men who are known to be reliable and successful want their accounts carried in a

Functions and Services Rendered by the Modern City Bank					
COMMERCIAL DEPT.	BOND DEPT.	TRUST DEPT.	SAVINGS DEPT.	SAFE DEPOSIT VAULT	SPECIAL DEPTS.
Checking accounts. Certificates of deposit. Foreign and domestic exchange. Letters of credit. Traveler's checks. Loans and discounts. Collections.	Purchasing. Sales. Investment counsel.	Executor of wills. Administrator of estates. Guardian of minors. Agent for individuals. Depository in escrow. Trustee under mortgages. Transfer agent and registrar for corporations. Fiscal agent. Receiver for firms and corporations.	Savings accts. Christmas Savings Club. Special savings plans.	Safety deposit boxes. Storage apartments.	Real estate. Foreign trade. Auditing. Income tax.

bank that has good standing both locally and abroad, for there is some advantage in drawing checks on a well-known bank. This is worth something especially to the business just starting. Creditors of a business respect that business a little more when its bank is well and favorably known.

When a business borrows from its bank, the bank usually desires the borrower to keep on deposit in the bank a definite amount of the sum he borrows—approximately 20 per cent of the loan in many cases. This is necessary in order that the bank may maintain a proper relation between deposits and loans, and to make it profitable for the bank to handle the account. Some banks are content to have the borrower maintain a balance of deposits as low as 10 per cent of the amount of a loan.

Many banks pay interest on commercial deposits above \$500 or \$1,000. The usual rate on the excess deposit is 2 per cent. Often this minimum amount above which interest is paid is not standardized, but is specially arranged in individual cases.

The Bank's Financial Strength. Federal and state banking laws are very strict; national supervision is searching; bonding and insurance safeguards usually furnish adequate protection; therefore, except for private banks, which have practically disappeared under the drastic legislation of a number of states, money is usually safe enough in any state or national banking institution. Nevertheless—

It is well before choosing a bank to consider points indicative of a bank's financial strength or weakness.

The paid-in capital stock of a bank may be relatively small, and yet the bank may be as sound as any other bank. A bank capitalized at \$25,000 may be just as sound as one capitalized at \$1,000,000, altho the smaller bank may not have sufficient funds to make loans to large borrowers.

An expensive building and fixtures do not always mean that the bank can lend money when it is needed. A strong bank may be found in a frame building which has only serviceable furniture and equipment. It is necessary to remember, at the same time, that a good building and good equipment, especially when acquired in the course of the growth of the bank, suggest progressive and sound banking policies.

A large surplus is a good indication of a bank's strength. This surplus usually represents a fund which has been accumulated from past earnings. It serves the same as paid-in capital stock as a reserve against loans and deposits, and it is a bulwark against any contingent liability that may occur. A bank may sustain losses thru bad loans or other causes, even tho it has exercised

reasonable care. With a large surplus, however, the losses can be charged off without impairing its capital stock. A large surplus is a very good advertisement for any banking institution. In case of insolvency, moreover, the holders of capital stock in a national bank and in nearly all state banks are liable for double the amount of their holdings.

Business Counsel and Advice on Investments. In choosing a bank where you can secure the best service, preference should usually be given to one that has made a speciality of your business or of lines of business similar to yours. Many banks to-day specialize more or less in particular lines of business. An automobile manufacturer, for example, will usually find that it pays to deal with a banker who is experienced in serving automobile manufacturers.

A banker who knows your business is better fitted to help you estimate what your loan requirements actually are and to give you the best service.

Some larger banks have regular service departments which undertake to help customers on their problems, whether or not they are strictly financial problems.

An automobile dealer in a Middle-Western town found himself in a serious financial difficulty. He went to his banker for help, and the banker went with his client to the scene of the trouble. The banker discovered that, altho the dealer was a business-getter, he was weak on routine, organization, management, etc. The business was in a bad tangle. The banker went all over the place, taking notes and making recommendations.

As a result, this automobile dealer's pay roll was reduced and a first-class accountant was put in charge of the office. The dealer's business was quickly put in order and his financial worries disappeared. Bankers know from long experience the close connection between financial difficulties and inefficient business management,

and they are a constructive force in business management.

THE VARIOUS CLASSES OF BANKS

The various classes of banks are—

- | | |
|-------------------------------|----------------------------------|
| 1. National. | 5. Savings. |
| 2. State. | 6. Investment. |
| 3. Loan and trust companies. | 7. Morris plan. |
| 4. Private. | 8. Federal and Joint-stock land. |
| 9. Intermediate credit banks. | |

National banks are chartered by the Federal Government under the National Bank Act. The restrictions placed upon the making of loans and the kinds of securities which they may accept confine them chiefly to the commercial business of lending to those who have a line of credit, for a period of 30, 60, 90, or 120 days.

State banks are organized under state banking laws. In many states the banking laws allow a greater latitude in the class of business a bank may accept, the amount of reserves it must maintain, and in the loan restrictions. In some states, the deposits in state banks are protected by a "guaranty fund." Both national and state banks are subject to close inspection.

A loan and trust company is a state banking institution which supplements the service of commercial banks. It is chartered to act in a fiduciary capacity, including such functions as executor and administrator for estates, guardian for minors, mortgagee in trust for bondholders, registrar of bonds, collector of interest on bonds, etc.

Private banks are unincorporated institutions that perform practically the same functions as national and state banks. Due to the fact that these banks are not governed by either national or state banking laws, there is no limit on their loans to individual customers as in the case of national banks or state banks in many states. Some states forbid the organization of private banks.

Savings banks are primarily a place for people to

deposit savings and in return receive a fair rate of interest. Some business concerns find it good policy to accumulate cash reserves, for various uses, in the form of a savings account.

Investment bankers are especially equipped to give counsel on investments and to handle purchases and sales of securities for their clients.

Morris-plan banks are organized to give the person of small income, such as wage earners and salaried employes, a means of securing small loans. The character of the borrower plus his earning power is the basis for credit with these banks.

Federal land banks and joint-stock land banks were organized under the Federal Farm Loan Act. The purpose of this type of bank is to aid in financing the farmer with long-term loans of funds to be used for agricultural purposes.

There are now also intermediate credit banks which specialize in facilitating relatively short-term loans to farmers; that is, loans running from 6 months to 3 years.

OTHER SOURCES OF LOANS

There are a number of sources, other than banks, from which the business man can at times profitably borrow and meet some of his requirements that for the time being perhaps cannot be handled thru regular banking channels. These sources are commercial-paper brokers and special credit companies, such as the automobile finance corporations, explained in the preceding manual.

The Commercial-Paper Houses. It is not a good policy to have a firm's bank credit constantly drawn upon to the limit. A firm whose finances are well managed will usually draw on its bank credit to the limit only as an emergency finance measure, when other sources of credit fail.

Important among these other sources are the commer-

cial-paper house, and the note broker. Next to the banker, the commercial-paper house is perhaps the greatest single factor in financing large-scale commercial operations.

The commercial-paper house buys the notes outright and resells them; it has largely displaced the old-time note broker who acted only as an agent for bringing buyer and seller together.

In addition to maintaining a line of credit with a bank or banks, a large borrower may have a commercial-paper house handle his short-term notes. The house sells the notes to various banks and investors. It has a large market for these notes and can take advantage of the lowest interest rates prevailing thruout the country. The cost of this kind of borrowing is usually somewhat lower than bank credit, and it has the advantage of relieving the borrower of the necessity of maintaining a specified minimum deposit. Thus the borrower can utilize the entire proceeds of his loans. These loans are clear-cut, and the notes purchased have to be taken up when due. The buyer knows there will be no requests for renewals.

In time of credit stringency, however, note brokers and commercial-paper houses are under no obligation to handle notes offered; while at such a time, a bank will want to take care of its regular customers. A borrower will therefore do well to maintain his standing with his banker.

A commercial-paper house first satisfies itself as to the financial status of the note maker. Then, as a rule, it purchases the notes outright, and disposes of them to buyers who offer the most favorable terms.

A business must have a very good financial record and be large enough to borrow fairly sizeable sums in order to make use of commercial-paper houses.

Credit Extended from Suppliers. It is not always necessary to borrow from a bank or note broker. Purchases

of raw materials or of salable merchandise may often be made on credit terms long enough to enable the purchasers to resell the materials or merchandise and receive payment in time to take care of payments on the purchases when due. In general—

Extension of credit from suppliers is a source of working capital the same as tho money were borrowed from a bank.

Suppliers also sometimes directly aid their customers in the development of their businesses and occasionally tide them over periods of financial difficulty.

Because of the aid which well-financed suppliers can give in emergencies, many business organizations choose carefully the sources from which they buy with that advantage in view.

Suppliers are especially helpful when the business man is lacking in experience and training, when the banks will not make a loan, and when the business is facing an emergency.

Loans from Insurance Companies. Insurance companies often make long-term loans on property. But the security must be high class. They are a possible source of mortgage loans to both large and small borrowers.

Special Credit Companies. The part which special credit companies play in the financing of the wholesale and retail distribution of automobiles was covered in Executive Manual 42. These credit companies often purchase installment-lien obligations secured by other commodities than automobiles, and they also sometimes loan on open accounts.

Borrowing thru the pledging of open accounts has the same effect as borrowing thru the sale of installment-lien obligations. It provides cash for the merchant or manufacturer who must sell on credit to meet competition and has not sufficient working capital to carry the

load. Instead of giving tangible security, his accounts receivable are pledged.

* * * * *

Such are the more important sources of loans for the business that needs to borrow capital. It is well to remember in financing a business that—

Regardless of the present need for borrowing, it is wise to prepare the way so that all sources of funds are open whenever they can be used profitably.

It is also well to remember that inefficiency of management anywhere in operating a business tends to increase the cost and the difficulties of financing a business. It not only increases the amount of capital required for operating the business, but also may stand in the way of securing the borrowed funds that are needed; and funds cannot be borrowed on as favorable terms when a business is not efficiently operated as a whole.

The balance sheet and the income (profit and loss) statement are important means of gauging the efficiency of management employed by bankers and other lenders of funds. Every executive needs to understand just what these statements show, how to analyze them, and how to have them prepared properly, because they are frequently called for by a banker when he is considering an application for a loan. He is interested in the relation between certain items shown on these statements, such as the relation between sales and the inventories of stock. Therefore, the executive must also understand these relationships. These important matters are taken up in Executive Manual 44—to be studied *after* Executive Problem 43, which follows, has been handled.

CHECK-UP ON PRINCIPLES.....	43

Use the following check-up to get the principles of this manual firmly fixed in mind. This will help you to handle the problem which follows. This check-up is entirely for your own personal use, so you need not send it in to the University.

	Check	
	Yes	No
1. Two men with several years' experience in the trucking business in an Eastern city desire to open a motor-transport interurban freight line. Prospects are good for building a flourishing business; however, the two men need \$20,000 more capital than they have. They propose to incorporate and to sell stock. Should they try to interest a few, rather than many, investors?		
2. The owner of a patent on a new electric-power, family washing machine wants to establish a manufacturing company. He plans to incorporate and to raise \$75,000 thru the sale of stock to the public. He comes to you for advice as to the best way to sell this stock. Would you recommend that he negotiate with an underwriting syndicate?		
3. A company manufacturing an automobile accessory needs \$5,000 permanent capital in excess of the amount contributed by the owners. The management proposes to obtain a 10-year loan of \$5,000, giving as security a closed first mortgage on its plant, valued conservatively at \$25,000, and at present free from liens. As an officer of the company, would you approve this step?		
4. A company organized to mine pottery clay wishes to obtain part of its permanent capital thru borrowing. It proposes to issue bonds secured by a mortgage on the clay lands. To make the issue attractive to investors, would it be desirable to have the indenture include any special provisions that would not be considered necessary in a mortgage given on the property of an electric power and light company?		
5. If you were promoting the development of an oil-producing company which owned promising land in a proved oil field, would you favor a stock issue in preference to a bond issue as a means of attracting investors?		

	Check	
	Yes	No
6. A company owning \$50,000 worth of bonds of a highly rated public utility desires to raise additional permanent capital. Rather than sell the bonds which mature in eight years, it prefers to obtain a long-term loan secured by the public-utility bonds as collateral. Do you consider it advisable to issue 10-year collateral-trust bonds?		
7. Is it ever more economical for a business firm to issue, say, 7 per cent bonds than $5\frac{1}{2}$ per cent bonds?		
8. When the Harmon Battery Company (described in Executive Problem 7) moved its factory from the large industrial center to the small town about sixty miles distant, it kept its city banking connection, previously established, even tho it opened an account with the bank in the small town. Would you have approved this?		
9. Robert Brennan has a small cleaning and dyeing business. He seldom needs to borrow more than a few hundred dollars from the bank at a time. In choosing a bank, should he regard the financial strength of the institution a prime consideration?		
10. An Eastern textile mill, anticipating expenditures for seasonal requirements, is about to arrange for a loan of \$150,000 for a period of six months. Its credit rating is high. Can it profitably use the services of a commercial-paper house?		

Executive Problem 43

HOW RAISE THE ORIGINAL CAPITAL?

Selecting the Method of Securing
Needed Capital

UNDER THE LASALLE PROBLEM METHOD



“IF I ONLY had the capital to swing the deal!”

Many a man with a business opportunity lacks the means to take advantage of it. Yet capital is to be had. Money is being raised every day to start new business enterprises. The problem here is to decide which methods are best under the particular circumstances.



Prepared by the Research and Consultation
Staff of LaSalle Extension University from an
interesting problem which it has carefully in-
vestigated and analyzed.

Executive Problem 43

HOW RAISE THE ORIGINAL CAPITAL?

Daniel Lindlay, an optician in Evanston, Ill., has had fifteen years' experience in the optical business. He knows this business thoroly from every angle—eye examination, prescription and fitting of glasses, and manufacture of lenses.

He has been in business for himself for the last five years and has developed a paying business. His profits for this period have been satisfactory, but they have been used in great part to pay off certain debts incurred in acquiring the establishment, to purchase new equipment, and to make payments on a home site. He values his present business at about \$7,500; his other assets consist of a high-grade public-utility bond with a ready market value of \$1,000, and about \$1,000 in cash.

His pleasing personality and his evident desire to provide his patrons with the best in goods and services have gained him many friends, both in a social and in a business way. He belongs to a local lodge, to the chamber of commerce, and to a business men's club. He enjoys the confidence of a number of oculists in Chicago and the North Shore suburbs, for he has been most careful and painstaking in all his work. The good will of these professional men is directly reflected in his volume of business, for they send him many desirable patrons.

Since coming to Evanston seven years ago he has carried a modest checking account with the Commercial State Bank. In later years, during his ownership of the optical business, he has had occasion to borrow small sums from time to time, on short-term notes, for use as working capital.

Evanston is a thriving suburban center just north of Chicago. Lindlay is an ambitious man in the middle thirties; he has a wife and three children; and he is con-

stantly on the lookout for a better business opportunity. His present business is profitable, but he feels that the possibilities of growth are not so great as they would be in a larger city. He has real executive ability—a quality of leadership that is recognized and appreciated by successful business men.

In Chicago, in the center of business activity (the Loop) is situated the Squair Optical Co., a business similar in character to that operated by Lindlay. It is owned by a man whose failing health makes him willing to dispose of the business at a figure which Lindlay regards as very reasonable. Under the management of A. H. Squair, a desirable patronage has been built up. Combining the favorable location with his own qualities and with his reputation among professional men will, Lindlay believes, result in greatly increased sales and profits.

But here's his problem. He hasn't the ready means with which to acquire the business. Squair is willing to sell for \$25,000, but he wants \$10,000 down and the remainder within a year. Lindlay has personally investigated the Squair establishment, and has assured himself that the equipment, fixtures, tools, supplies, lease, and goodwill are really worth more than the sum asked, and that Squair is acting in good faith in offering to sell at a bargain price so that he may get needed cash.

Basing his estimates on the business done by Squair and the profits Squair has made in the past five years, Lindlay figures that he can do a business of \$50,000 a year (gross receipts) and show an annual profit of \$20,000 (after paying all operating expenses, but before charging the business with salary to himself).

Lindlay has consulted his lawyer, and has taken the following steps. He has entered into a contract with Squair whereby he agrees to purchase the Squair business for \$25,000—\$10,000 to be paid in cash within sixty days, two notes for \$7,500 each to be given, one due in eight months, and the other in fourteen months. He has sold his bond and has made an initial payment of \$1,000 on the contract, as earnest money. (This sum becomes forfeit if the terms of the contract are not complied with.)

He wants to form a corporation and to turn this purchase contract over to the corporation. The Illinois law provides that three or more adult citizens of the United States, one of whom must be a citizen of the state, may incorporate under the general corporation act. The organizers must sign a statement setting forth certain facts, among them the total amount of authorized capital stock and the amount of such stock which it is proposed to issue at once. The statement must show that payment has been made for at least one-half the stock which it is proposed to issue at once. Shares may be

issued for cash, for property, or for services. The value of property or services is appraised by the incorporators.

Lindlay's next move will be to interest others in the proposed enterprise. He needs \$9,000 in cash within sixty days to complete the first payment on the purchase. When organized, the corporation will need about \$2,000 in cash working capital.

Lindlay has already advanced \$1,000 in cash. He plans to turn the other \$1,000 of his liquid capital over to the corporation for use in meeting the many expenses incident to organization efforts. If his plans mature, he intends to sell his Evanston establishment. He feels that he can realize at least \$6,000 from its sale—maybe more—but less than half this amount in cash. At any rate he is not counting on having more than \$2,000 of his own money available for investment for at least six months.

Naturally, Lindlay wants to control the policies of the new corporation. He also wants to raise outside capital. Furthermore, he wants to provide for reasonable capital expansion thru growth, and he wants to insure retention of control. For his services as general manager he plans to draw a salary of \$5,000 a year. What he can save out of this and out of his share of the profits he intends to use in acquiring stock in the corporation.

His intention is to incorporate for \$50,000, but to issue stock for only part of this amount at the present. This capitalization will provide room for growth. Lindlay now comes to you for recommendations as to how to raise the needed cash capital, how to provide for the payment of the two \$7,500 notes, and how to maintain control of the corporation.

With the aid of the inclosed working papers you are to analyze this case and work out a practical plan to meet Lindlay's requirements.

BUSINESS MANAGEMENT

FINANCIAL STATEMENTS AND LOANS—Being Executive Manual 44, on Financing a Business, in a Complete Plan of Training and Service for Executive Work

*Investigated, organized, and presented by
the research, consultation, and editorial
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Especially acknowledging
the advice and co-operation of

W. P. G. HARDING, Governor
Federal Reserve Bank of Boston
Boston, Massachusetts

R. G. RHETT, President
Peoples National Bank
Charleston, South Carolina

JOHN McHUGH, President
Chase National Bank
New York City

OLIVER J. SANDS, President
American National Bank
Richmond, Virginia



LaSalle Extension University
Chicago

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FINANCIAL STATEMENTS AND LOANS

Part I

ANALYZING FINANCIAL STATEMENTS

A WELL-ORGANIZED accounting procedure in a business provides the management with accurate and complete facts concerning the current financial condition of the business. These financial facts, in the form of figures properly classified and summarized, indicate the degree of efficiency attained in operating the business.

A keen interpreter of these financial facts can form accurate judgments or make sound decisions on general problems of business policy and on problems that relate to departmental matters. Here we are interested in the fact that—

Efficient management of finance requires accurately summarized figures on all operations—and the ability to interpret these figures constructively.

In this executive manual we shall consider the use of financial figures summarized in the form of financial statements, particularly their use in calculating the requirements of money and credit and in securing money and credit to meet these requirements.

The Uses of Financial Statements. Financial statements show more than the condition of a firm's finances, such as cash on hand and in the bank, credit extended, money borrowed, etc. They reveal both weak and strong spots in the operation of the business—to those who know how to interpret them. They serve both the borrower and the lender of money or credit—as well as the operating executive.

A prospective borrower must know how his finances stand in relation to various operations in his business;

and a lender wants to know the same thing before he assumes the risk of becoming a creditor.

The viewpoint and functions of lenders of money or credit, such as banks, suppliers of merchandise, commercial-paper houses, financing companies, and so on, were explained fully in a previous executive manual. Let us here recall to mind the fact that, whoever the lender may be, and whether the loan sought is for a long or a short term—

A borrower is more likely to obtain the loan he is seeking if he is able to offer convincing proof of his credit worthiness in the form of a comprehensive, reliable financial statement.

Many business firms find that it pays to have their financial statements certified by independent auditors. Banks, in particular, favor financial statements that are certified by public accountants. They and other suppliers of credit are usually willing to accept such statements as accurate representations of a borrower's financial condition as of the date of the certified statement.

What the Banker Needs to Know. Since a large portion of business loans are obtained from banks, it is well to have a clear understanding of just what bankers want to know before they grant a loan. Bankers, as a rule, are more thoro in their investigations of the credit worthiness of those to whom they make loans than are many other lenders. If borrowers are able to satisfy the requirements of a bank, they can also, in all probability, satisfy the requirements of other classes of lenders or creditors.

Regardless of the loaning agency and its requirements, it is well for the borrower to "aim high" in giving the prospective lender all the facts required in making a decision for or against granting the loan.

That is to say, it is better for a borrower to supply, at once, more facts than are absolutely necessary, rather than not enough, in order to insure favorable action on

his request for a loan; for once a borrower has been "turned down" on such a request, he finds it more difficult later to secure a loan from that source.

Many banks provide printed forms to be filled out by applicants for loans. These forms ordinarily call for comparative balance sheets and income statements covering at least two years. In addition, they usually include a number of leading questions on matters pertaining to depreciation, allowances for bad debts, discount policies, and questions on unusual items that may appear in the statements.

There is, however, a tendency among some banks to do away with printed forms, and to insist on independent audits being made direct to them by certified public accountants.

What the Balance Sheet Should Show. The balance sheet is a statement of the value of the assets, liabilities, and net worth of a business. The assets are classified on the left-hand side of the statement, and the liabilities and net worth are grouped on the right-hand side. (In England, however, assets appear on the right-hand side of the balance sheet.) A typical balance sheet is shown in Figure 1.

Under assets are included all values that are owned by the business, including property owned and receivables such as customers' accounts and notes receivable. Liabilities include obligations of various kinds owed by the business. The net worth is the difference between the total assets and the total liabilities.

The assets are commonly grouped into four classes:

Current assets: such as cash, marketable securities, accounts and notes receivable, inventories—values which can and will be converted into cash within six months or at most a year.

Fixed assets: such as plant, machinery, and other equipment necessary to be maintained for the continuous oper-

ation of the business—values that are of a permanent nature.

Intangible assets: such as goodwill, patents, franchises, and copyrights.

Deferred charges: such as prepaid insurance, prepaid rent—representing future expenses already paid.

The liabilities—one of the two main groups shown on the right-hand side of the balance sheet—are usually shown in two divisions:

Current liabilities: such as accounts and notes payable, accrued interest and taxes, and accrued wages—obligations incurred thru daily operations and maturing within a year.

Fixed liabilities; such as bonds payable and mortgages payable—long-term obligations that mature more than a year hence.

Net worth may be shown in a lump sum under capital in the case of a single proprietorship, or it may be divided as follows in the case of a corporation:

Capital stock.

Surplus.

Reserves—a part of surplus set aside for hazards of the business.

Net worth represents the amount originally invested in the business by the owners, plus the amount of earnings accumulated and left after profits have been distributed among the owners.

The balance sheet is sometimes set up in condensed form without showing the items classified in groups, but most business concerns now prefer to have classified balance sheets showing the items that make up each group.

The balance sheet provides a basis for determining the true financial status of a business—when the various items are properly interpreted.

Balance Sheet Items Explained. It is very important that a business executive know what the principal items of a balance sheet are, and understand what these values mean, both to the managers of a business and to bankers

and other prospective lenders or creditors. Following are the principal items and what they mean:

Cash on hand and in bank—Amount of cash on deposit with banks, and in safe or cash drawer. The cash account should always be sufficient to meet current obligations as they mature, and to provide a balance large enough to make the account profitable for the bank or banks to carry. Banks usually require that borrowers maintain deposits up to 20 or 25 per cent of their bank loans.

Accounts Receivable—Amounts due from customers who have purchased on open account. In analyzing this item, the lender will check up on the bad accounts and make due allowance for doubtful ones. He will also indicate and observe probable dates of collection, to see whether or not cash will be available from this source to meet current liabilities.

Notes Receivable—Notes taken in settlement of obligations. Notes may represent claims on customers who have bought goods or services, or claims on borrowers. In judging this item the prospective lender wants to know if any past-due notes are included, if any are merely renewals of past-due notes or accounts, and if any are partially or wholly uncollectible. Notes from employees, members of the firm, or relatives, given for money borrowed, should be shown separately on the balance sheet.

Inventories—Raw materials, work in process, and finished goods. In many concerns these values make up a considerable part of current assets. Lenders also want to know the methods used in valuing inventories—whether or not actual stock counts have been made and whether values are set up at purchase prices or at prevailing market prices. It is usually considered best practice to value inventories at cost or market, whichever is lower.

Plant and Equipment—Permanent assets purchased with the concern's own funds or with funds secured thru long-term borrowing. They are not intended for resale. Lenders want to be assured that these items are valued at their true present worth—that is, whether or not a fair percentage has been charged off periodically for depreciation; increases in value should not be included until it is certain they are permanent, and then only after a careful and conservative appraisal of the present value.

Goodwill, Patents, and Copyrights—These are intangible values, but they are so linked up with the business itself

that very little could be realized from them independently. Many concerns carry these items at only a nominal sum. Lenders will usually discount such values or disregard them entirely.

Accounts Payable—Amounts due other firms for goods purchased on open account. These should be analyzed as to terms of purchase, due dates, time outstanding, and amounts. When compared with cash and other current assets the firm's credit position can be determined. Lenders want to know if accounts are paid promptly and if cash discounts are regularly taken.

Notes Payable—Notes given for purchases or money borrowed from individuals or banks. Lenders wish to know whether any notes are past due, whether any are renewals of past-due notes or accounts, and to whom they are owed. Notes payable to relatives and friends usually mean that credit has been exhausted in other fields. Notes owed to several banks may indicate a need for a line of credit larger than a single bank can furnish.

Bonds and Long-Term Notes—Evidences of long-term indebtedness. These may be secured by mortgages on fixed assets, or by indorsements of individuals, or they may be unsecured. Long-term notes are usually given when permanent assets are purchased or when funds are secured for additional working capital.

Capital Stock—Investment of stockholders. Lenders want to know the various classes of stock outstanding, and their respective amounts.

Surplus—Earnings accumulated in the business from past operations. In some cases, however, surplus may be created at the outset if stock is sold at a premium.

Reserves—Accounts which show the amounts provided for depreciation, probable losses from bad debts, and operating contingencies. Also surplus appropriated for some specific purpose and appreciation of fixed assets are termed reserve accounts.

The Income Statement. The income, or profit and loss, statement is a report on the progress of a business. It shows not only the amount of profit or loss incurred in the operation of a business during a period but also what has caused this profit or loss.

An income statement is most valuable when it is set up in comparative form, covering a period of two or three

years. A banker will analyze such a comparative income statement, and note increases and decreases in sales, purchases, expenses of various kinds, gross profit, net operating profit, and net profit.

The net operating profit (or loss) is obtained by subtracting operating expenses from gross profit. This figure represents the earning power of a business. If the net operating profit continues to show an increase from year to year, the banker is willing to extend a credit line on short-term notes, even tho the current ratio—that is, the ratio of current assets to current liabilities—may not appear so favorable. The form of the income statement has been standardized to a great extent by the Federal Reserve Board, and by bankers' associations.

A business man who is not thoroly familiar with the principles of financing may undertake to determine a borrower's financial position by analyzing his balance sheet only, without studying his income statement. But this would be an inadequate analysis, because—

From the standpoint of management or from that of a prospective lender, the true financial condition of a business can be determined only from a careful, thoro analysis of the balance sheet and income statement, viewed in all their important interrelations.

It is important to understand how balance sheets and income statements, such as those shown in Figures 1 and 2, are made up in order to make them of greatest value to the business.

Making up Financial Statements. Financial statements are valuable to the business man or banker provided they are accurately prepared according to sound and conservative accounting procedure.

The omission of important items from a statement may be evidence of incorrect accounting procedure. Many concerns doing business on a credit basis accept short-term notes from customers to cover their accounts. These notes may then be discounted at the bank. In doing this

COMPARISON OF BALANCE SHEETS
BAKER-FLEMING MANUFACTURING CORPORATION
for Year Ending December 31, 1924

ASSETS		Per cent Increase or Decrease		LIABILITIES AND CAPITAL			
	Dec. 31, 1923	Dec. 31, 1924		Dec. 31, 1923	Dec. 31, 1924	Per cent Increase or Decrease	
Current Assets:							
Cash on hand and in bank.....	\$ 29,162.57	\$ 65,325.32	+ 124	\$ 53,652.38	\$ 87,414.93	+ 44	
Accounts Receivable..	160,787.28	171,813.48	+ 7	36,037.62	56,750.26	+ 67	
Inventories.....	195,812.23	265,773.72	+ 36				
Marketable Securities,	9,344.18		...	10,712.56	17,585.13	+ 64	
Total Current Assets	\$385,762.08	\$512,256.70	+ 33	12,356.14	13,677.47	+ 11	
Fixed Assets:				Total Current Liab..	\$112,758.70	\$175,427.79	+ 56
Land, Buildings, and Equipment (Less Depreciation).....	334,387.52	385,912.83	+ 15	Fixed Liabilities:			
				10 yr. 7% M't'g Bonds	68,200.00	103,200.00	+ 51
				5 yr. 7½% Notes...	20,000.00	20,000.00	...
				Total Fixed Liabilities	\$ 68,200.00	\$123,200.00	+ 81
Copyrights, Trade-Marks, Goodwill, Etc.	10,000.00	10,000.00	...	Total Liabilities.....	\$180,958.70	\$298,627.79	+ 65
Deferred Charges:				Capital:			
Prepaid Interest, Insurance, etc.....	4,125.64	7,831.47	+ 90	8% Preferred Stock	61,600.00	61,600.00	...
				Common Stock.....	139,500.00	139,500.00	...
				Reserves for Contin-	\$201,100.00	\$201,100.00	
				gencies.....	10,000.00	10,000.00	...
				Surplus (Free).....	342,216.54	406,273.21	+ 19
				Capital.....	\$553,316.54	\$617,373.21	+ 11
Total Assets.....	\$734,275.24	\$916,001.00	+ 25	Total Liab. and Capital	\$734,275.24	\$916,001.00	+ 25

Figure 1. A comparative balance sheet of a representative business concern. After reading the manual, turn back to this balance sheet and analyze it to find out what it tells about the financial condition of this business.

the business that holds the notes must indorse them and assume a contingent liability for their payment, in the event that the makers refuse or fail to pay at the date of maturity. Thus, whenever notes are discounted at the bank, the proper procedure is to set up on the books a contingent liability account—a Notes Receivable Discounted Account—which is credited with notes that are discounted, and charged later when the maker pays the notes. This contingent liability account should be shown on the balance sheet.

Other contingent liabilities that are frequently omitted from the balance sheet are incompleting contracts or pending law suits. These items should usually be shown in a footnote to the balance sheet. Banks are also careful to note any omission of accrued expenses—such as interest, taxes, wages, and salaries, which have accumulated, but are not due to be paid until a later date.

Because the trends of progress made by the business are revealed from a comparison of financial statements of two or more periods, such as two years in Figures 1 and 2, it is obvious that if one kind of accounting procedure were used during one year and another kind during another year, comparisons would probably be misleading. For example, if a business “writes off” a large amount for depreciation on buildings and equipment in a prosperous year, and during a slow year “writes off” a smaller amount, the statements for the two years cannot be accurately compared. Likewise, if certain assets are assigned one value during a favorable year, and are assigned a much higher value for the next year (because it happens to be a poor year), the lender will naturally question the accuracy of the whole statement—unless he is given evidence that the values of assets have actually been increased thru improvements.

While no fixed rule can be applied for all cases as to the valuations of inventories—since amounts of stock on hand are constantly changing and prices and costs may

COMPARISON OF INCOME STATEMENTS
of the
BAKER-FLEMING MANUFACTURING CORPORATION
for the years 1923 and 1924 ending December 31

	Year 1923	Year 1924	Per cent of Change
Sales (Net).....	\$638,748.78	\$855,443.86	+34
Deduct:			
Cost of Sales:			
Labor, Material, and Other			
Charges.....	367,368.54	516,502.74	+41
Depreciation and Depletion...	48,414.61	59,135.59	+22
Total Cost of Sales.....	\$415,783.15	\$575,638.33	+38
Gross Profit on Sales.....	\$222,965.63	\$279,805.53	+25
Deduct:			
Selling, Administrative, and Gen- eral Expense.....	141,584.22	170,431.27	+20
Net Profit on Sales.....	\$ 81,381.41	\$109,374.26	+34
Other Income: Rentals, Interest, Discounts, Royalties.....	2,753.97	3,342.65	+21
	\$ 84,135.38	\$112,716.91	+34
Deduct:			
Interest on Funded Debt.....	4,620.16	4,958.42	+ 7
Interest on Current Debt.....	7,518.79	8,022.68	+ 7
Total Interest.....	\$ 12,138.95	\$ 12,981.10	+ 7
Net Income before Taxes.....	\$ 71,996.43	\$ 99,735.81	+39
Deduct:			
Taxes.....	22,356.33	29,417.53	+32
Net Income before Dividends...	\$ 49,640.10	\$ 70,318.28	+42
Deduct:			
Dividends on Preferred Stock...	\$ 4,928.00	\$ 4,928.00	....
Dividends on Common Stock....	8,596.58	10,745.73	+25
Total Dividends.....	\$ 13,524.58	\$ 15,673.73	+16
Balance to Surplus.....	\$ 36,115.52	\$ 54,645.55	+51

Figure 2. Comparative income statement. This statement shows the progress of the business. It is a story, in condensed form, of the operations that finally result in net profit or loss for each year. A study of the various items and a comparison of some of the most important ones with certain items on the balance sheet (as explained in Part II of this manual) supply management with facts that are important in the control of operations.

vary—every business concern should adopt a sound policy and adhere to it consistently. If inventories have a “slump” that seems to be of a more or less permanent nature, the inventory may be written down, and a loss shown. If the original cost were included in the statements, profits and assets would be overstated. Overstatements or inaccuracies of any kind in financial statements are never advisable.

The business executive should test his financial statements to see whether or not they conform to sound accounting principles or practice. The assigning of values to items in a balance sheet should conform as nearly as possible to the best accounting practice in the trade or business and should be consistent from year to year.

Frankness and Truthfulness Essential. Many concerns, even when they are not seeking credit, send copies of their statements to their banks, suppliers, and credit-rating agencies. This frankness and willingness to show facts as they really are nearly always prove profitable when the time comes to apply for credit. Statements that are complete and accurate help to maintain cordial relations between borrower and lender. It is always poor policy for a business man to try to conceal weak spots from the discerning investigator. He can usually expect to receive at least *some* help if he is frank, whereas he is quite likely to go away empty handed if he indicates any desire to hide conditions or facts.

When a firm's financial condition is not as sound as it should be, a frank admission of the fact, by honest, accurate statements, will accomplish more for the credit seeker than any clever effort to “dress things up.”

A banker's good will and wise counsel are worth more in the long run than any loan obtained thru clever manipulation of figures.

“A business man came to me for a loan not long ago,” said one small-town banker, “and presented his financial

statement. I got from the file his last previous statement. I saw at a glance that his property value had been increased by \$4,000, while his net worth showed a decrease of several hundred dollars.

"Now, I could not see how his property had increased in value from the time he made his previous statement. I asked him about it, and he frankly admitted that he had offset certain losses in his small business by increasing the figure for his vacant land, because he thought the property was worth more than the value placed on it in his previous statement.

"Whether or not that was true, the fact remained that he had sustained certain losses, and I had to turn him down on the loan he wanted, for the time being—until I could find out definitely the cause or causes of his losses. Good policy would not allow me to do otherwise."

Analyzing Financial Statements. That simple case illustrates how highly bankers value financial statements when they consider the granting of loans.

How do bankers and other lenders of money and credit get so much information from these statements? What methods do they use to put life into the cold figures of a financial statement?

The loan manager of one large bank has tabulated questions to guide him in his analyses of financial statements. These questions are listed here because they provide the banker or other lender of money or credit with a basis for analyzing financial statements. In reading them over, you will note that the same questions may be used also by the financial manager or other official of a concern in determining the true condition of a business.

What Your Banker May Ask You When You Seek
a Line of Credit

I. BALANCE SHEET

A. CURRENT ASSETS.

About Cash on Hand and in Bank:

Is the cash balance normal, or unduly large in anticipation of an audit?

Does the cash contain any I.O.U.'S or memos covering withdrawals or expenses of officers or employees?

Is any part deposited with questionable concerns or institutions in process of liquidation?

About Notes Receivable:

Is the concern doing a cash business?

Do any of the notes represent loans to officers, employees, relatives, etc.?

Do the notes represent actual sale of goods?

Do the notes represent recent transactions, or are they notes given to cover past-due accounts?

Are there any notes which have been renewed?

Do the notes mature within ninety days, or do they extend over longer periods of time?

What proportion of the notes are discounted with the bank?

Are the notes secured by collateral? If so, what is the value of this collateral in comparison with the face value of the notes?

Are there any accommodation notes?

Are there any notes due from affiliated firms?

Have trade acceptances been taken for past-due accounts?

Are the trade acceptances for a period longer than the normal terms of sale?

About Accounts Receivable:

What is the total amount of accounts receivable less than thirty days past due? The total more than thirty days past due?

Have any of the accounts receivable been assigned?

Are any accounts included due from related or affiliated concerns for sales or advances to them?

Are any accounts included due from officers, employees, relatives, etc.?

Have any reserve accounts been set up to provide for bad debts?

Have all uncollectible and worthless accounts been charged off?

About Inventories:

Is the finished merchandise up to date and marketable, or does it include shopworn, old, and out-of-date stock? Is there a constant demand or ready sale for the finished merchandise, or does it consist of luxuries or of a line of goods subject to sudden changes?

How is the inventory taken—by estimate, or by actual stock count?

How are values assigned—as to cost, or as to market value?

How are trade and cash discounts handled?

Can the goods in process and the raw material be sold readily without much loss?

About Investments:

Have any of the securities been assigned?

Are the securities available as “quick assets”; that is, can they be turned into money quickly in time of need?

Do any of the investments include deeds and mortgages?

Is the market value of the securities less than the book value?

Are the securities those of affiliated or subsidiary companies? If so, are any obligations thereby contracted thru ownership?

Does the concern have a tendency to speculate in securities?

B. FIXED ASSETS.

About Real Estate, Machinery, and Fixtures:

Has the concern a good title deed to the land? Has the deed been properly recorded?

Are the land and plant encumbered by any mortgages?

If so, to what extent, and who holds the mortgages?

Are the buildings in good condition for business purposes? How old are the buildings, and of what material—wood, brick, stone, or what?

Are there any unpaid taxes, assessments, or other liens against the property?

Has there been set up a reserve for depreciation on building and plant equipment? If so, what is the method for determining the rate of depreciation?

Is the property adequately insured?

What is the value of the machinery in case of liquidation?

What is the rate of depreciation on machinery and equipment?

Does the firm hold clear title to all the machinery and equipment, or is some of it covered by chattel mortgages?

About Goodwill, Patents, Trade-Marks, etc.:

Are these conservatively valued?

C. CURRENT LIABILITIES.

About Notes Payable:

Are the notes given in payment for purchases of current assets—raw materials or merchandise?

Have they been given in current transactions, or for overdue accounts?

Are any of the notes made payable to local bankers?

If so, are they secured by collateral?

Are any of the notes payable to banks indorsed or guaranteed by individuals interested in the business?

Are any of the notes given for money borrowed from relatives, friends, officers, directors, etc.?

Are there any notes (commercial paper) sold on the open market or thru brokers? If so, how is the money being used?

Has any of the money borrowed been used for paying dividends?

Have any of the notes payable been renewed?

About Accounts Payable:

Are any of the accounts payable past due?

What amount represents regular trade obligations?

Are any of the accounts payable due to affiliated concerns, directors, officers, employes, relatives, friends, etc.?

Are any of the accounts payable secured by collateral or in some other manner?

Are all accounts payable actually stated on the books?

About Accrued Liabilities:

Have all items, such as interest, taxes, wages, salaries, etc., that have accumulated to date, but are not yet due, been indicated on the statements?

About Contingent Liabilities:

Has the concern indorsed any notes for others?

Are there any unfilled contracts for receipts or delivery of goods?

D. FIXED LIABILITIES.*About Bonds and Long-Term Notes:*

What is the total amount of bonds and long-term notes outstanding, and for what purposes were they issued?

What provision has been made for the retirement of the bonds (and notes), and when are they due?

Are the bonds (or notes) secured by a lien on all the fixed assets, or only on a part?

If secured by mortgage, is there any sinking-fund provision in the mortgage?

Does the mortgage stipulate that the current assets must be maintained at a certain amount in excess of the current liabilities?

Has the mortgage been properly recorded?

Is there any interest unpaid on bonds or mortgages?

E. CAPITAL, SURPLUS, AND RESERVES.

What classes of stock are outstanding? In what amounts? Are all capital shares paid in full?

How has the surplus account been created and built up?

Have any dividends been declared out of surplus arising from the sale of stock?

Have sufficient reserves been set up?

II. INCOME STATEMENT

How do the sales and profits for the period covered by the last statement compare with those of past corresponding periods?

What is the source of profits or cause of losses?

Are the expenses of operating heavy or normal?

Analysis to Find Causes of Poor Financial Condition.

Where financial statements can pass the test of satisfactory answers to the above questions, well and good; management then has assurance that affairs are in good shape. Prospective lenders also have a sound basis on which to extend credit.

It is one thing, however, to learn from an analysis of financial statements that something is wrong, and another thing to locate the causes and prevent a recurrence of the trouble. First, to recognize that trouble exists; second, to know its cause; then to remedy the trouble—

that is the sequence of procedure. Financial statements help us especially on the first and second steps. Therein we can see the close relation existing between the financial condition of a business and the efficient operation of all the various departments. Working capital may be scarce because credit is being extended too leniently. Profits may be low because costs are unreasonably heavy. Continuous operation may be interrupted because the output of the different departments is not evenly balanced; and so on.

Before a banker or other supplier of credit extends a loan, he will want to trace to their source the causes which make the financial statements show an unfavorable condition.

Where a poor financial condition exists, the lender's judgment in extending credit will be based not so much upon unsound conditions which the financial statements reveal as upon the causes of those conditions.

Where the cause can be readily removed, the lender may see his way clear to extend a loan or credit which will put the concern on a thoroly sound basis once more, as more fully explained in the major section of this training service on credits and collections, which follows this section on financing a business.

Moreover, by analyzing his current financial statements, the business man may be able to eliminate weaknesses in his business which would otherwise cause his bank or suppliers to shut off his line of credit. Then, when he comes to need credit, he will find his credit suppliers more willing to co-operate with him, and he will have greater assurance of financial assistance at a time when he needs it.

The Personality of the Borrower. It should not be forgotten that, apart from financial strength, bankers weigh carefully the personal element involved in loans. For instance, it may not matter how much money a man may

have behind him; if he is untried, he presents a serious personal risk. Investigation reveals the fact that many men, well financed, have started out brilliantly and in the end have failed simply because they lacked the balance, financial acumen, and vision that come from right training. Therefore, banks usually proceed cautiously in granting lines of credit to men who have not as yet demonstrated their ability to handle successfully the affairs of a going business. Other lenders take much the same view as bankers.

The danger of granting too much credit is illustrated in the experience of an automobile company. The head of the concern was a successful advertiser, but he was untried as a financial executive. Reverses came; he could not meet them. His business failed, and even a reorganization could not put the company on its feet.

Bankers do not want to lend money to a business the management of which is weak in any one of its main functions.

Promptness in taking care of obligations is another point on which the banker tests prospective borrowers. Prompt payments show a sense of obligation that indicates good character.

Still another point of great importance is the adaptability of the borrower to the business he is in. A banker sizes up a man's fitness for his job quite minutely, and he takes little interest in lending to a grocer who obviously would make a much better farmer. Any unfitness or a tendency to speculate reflects unfavorably on a man's borrowing capacity.

Once a borrower has favorably impressed his banker and obtained his line of credit, he should remember that, besides presenting comparative financial statements at frequent intervals, he should keep his deposit balance up to the amount required by his bank.

Collateral Security. Commercial credit, in the form of

short-time loans granted by banks, and in the form of sales made by suppliers on open account, is extended only after the lender has assured himself of the borrower's willingness and ability to meet his obligations. Frequently, however, the lender may feel the necessity of requiring some kind of security for the payment of the loan. Collateral security in the form of readily marketable stocks and bonds, also notes and acceptances, is the most acceptable type of security for short-time commercial loans.

If a concern has good collateral, it can usually borrow without question. Banks lend up to a certain percentage of the market value of the collateral. This percentage varies with the specific collateral pledged, according to its present and probable future market price, its marketability (the readiness with which it may be turned into cash if necessary), its intrinsic value, etc. A lender wants a sufficient margin to cover any reasonable fluctuations in the market price, in order to insure himself against loss in the event of a forced sale should the borrower fail to meet his obligation.

Loans Secured by the Borrower's General Credit. Collateral security is not always required by the lender, who may be satisfied that the general credit standing of a business is strong enough to give him adequate assurance that the loan will be repaid when due.

Commercial transactions are being carried on every day on credit extended without requiring collateral security. The integrity, the ability of the borrower to pay, and the purpose for which the loan or credit is to be used satisfy the lender that the loan is safe without collateral security.

Such extensions of credit are based on a full consideration of the facts in each case as shown by satisfactory financial statements, supplemented by any necessary explanations of doubtful items appearing on the financial statements, as previously explained. Many small

firms do not possess readily marketable securities in large enough amounts to serve as collateral for current borrowings.

There are, however, many kinds of collateral. Almost any documentary evidence representing value can be used as collateral security for a loan. Property of any kind—real estate or chattels—can be used as security at a value or at a percentage of face or market value agreed upon by both borrower and lender. But—

A borrower should be extremely careful not to pledge so much of his assets as to impair his credit standing and his working capital.

When a firm pledges its accounts receivable, for instance, it ties up an important part of its working capital. The pledging of accounts receivable is regarded by most bankers and other suppliers of credit as a sign of financial weakness. When a firm has given all or part of its accounts receivable as security for a loan, a banker is seldom willing to grant a loan secured only by the general credit of that firm.

There are many concerns, however, that make sales on comparatively long terms, taking notes and acceptances in payment. To avoid tying up unnecessarily large amounts of working capital, they often find it desirable to sell or discount such evidences of indebtedness, or pledge them as security for current borrowing. Such practices may be in entire accord with good financing procedure, provided the proper relations between various balance sheet and income accounts are maintained, as explained in Part II of this executive manual.

The Right Attitude toward Collateral Requirements. The desire for collateral security on the part of a banker or other lender is not necessarily a reflection on the ability or integrity of the borrower. It may be that the very nature of the undertaking requires collateral security to afford a satisfactory guaranty of the payment of the loan.

Many brokers and trading concerns of high standing constantly handle large quantities of goods that are perishable or otherwise may unexpectedly change in value. Often these goods represent a value that is much larger than the borrower's invested capital. Profits are made on very small margins with rapid turnover of the stock. Such business concerns often need large extensions of credit for short periods. Banks and other financial agencies naturally need to be fully protected in such cases, so they require security in such forms as warehouse receipts, bills of lading, and collateral of various kinds.

But before the question of collateral is considered at all, tests are applied to determine definitely the financial strength of the borrower, as explained in preceding pages. In Part II of this executive manual we shall take up the subject of "Financial Ratios," and show how financial statements are analyzed and interpreted with the aid of seven practical ratios or comparisons. It is necessary for every executive to be familiar with these financial ratios, because they are useful in controlling the operation of the business as a whole, and of its main departments as well, in keeping the finances of a business in that healthy condition which assures to it an adequate supply of working capital.

FINANCIAL STATEMENTS AND LOANS

Part II

FINANCIAL RATIOS

EARLY in this training service, in our preliminary survey of the principles of profitable management, it was made clear that the success of a business enterprise depends mainly upon three factors: internal management, competitive activities, and general business conditions.

A business executive may keep himself constantly informed on competitive activities and general business conditions, but he will be unable to make the most effective use of this information unless he also has constantly before him a clear picture of all the operations going on within his organization.

In Part I of this executive manual, we saw how financial facts not only serve as a guide to internal management but also aid in borrowing funds. Let us now secure a better understanding of the methods of interpreting financial statements in order to be able to lay our finger on points of strength or weakness as revealed by comparisons of various items on the financial statements. These comparisons are commonly known as financial ratios. We need to understand these ratios, because they are of definite significance as guides to executive control of a business.

Two Groups of Financial Ratios. We shall take up these ratios in two groups, as follows:

Group 1. Balance-Sheet Comparisons:

1. Current assets to current liabilities.
2. Debt to net worth.
3. Net worth to fixed assets.

Group 2. Income Statement and Balance-Sheet Comparisons:

1. Sales to receivables.
2. Sales to inventories.
3. Sales to fixed assets.
4. Net income to net worth.

Other ratios may also be used, such as the ratio of merchandise inventories to accounts receivable, of sales to net worth, of operating profit to total capital, of operating profit to volume of business, of gross earnings to volume of business, etc. To serve our purposes, however, we may center our attention on the seven important ratios listed above, since a careful consideration of these will give a comprehensive picture of a firm's financial condition without any confusion or complications.

Current Assets to Current Liabilities. The comparison of current assets with current liabilities is known as the current ratio, or the working-capital ratio. It shows whether or not the firm is able to meet its current obligations. It has long been used by bankers, credit men, and business executives generally, in reaching decisions as to the granting or seeking of credit.

The first element of this ratio, current assets, is the sum of such items as cash, accounts and notes receivable, and salable inventories. These are assets from which funds are to be realized for meeting current liabilities; that is, for meeting obligations to pay out money in the near future. The current assets should be liquid in character; that is, readily convertible into cash or its equivalent within a reasonably short time.

Current liabilities, the second element of the ratio, are to be paid with the proceeds realized from the sale of current assets in the ordinary course of business.

Current notes and accounts payable, trade acceptances payable, accrued interest, wages, and taxes are some of the items included in current liabilities. They are, for all practical purposes, short-time obligations.

The excess of current assets over current liabilities is known as the firm's net working capital. Obviously, a lack of sufficient net working capital may hinder the firm in its current operations and retard greatly its future expansions. If, however, the net working capital is constantly increasing, the credit position of the business will be constantly improving. The trend of change in this ratio is very significant in determining whether or not to borrow or lend and how much may be borrowed or should be loaned.

Ratios and Their Significance Vary. Before further analyzing the ratio of current assets to current liabilities, let us briefly consider the important fact that—

In any going business, ratios are variable, never constant; they undergo fluctuations from day to day, from week to week, from season to season; and they must always be considered in relation to the current activities of the business and of the field in which it operates.

A certain ratio, such as the ratio of 2 to 1 for current assets over current liabilities, that is considered favorable for one business or type of business, may be considered unfavorable for another.

This, by the way, is an important reason why the financial executives of a business should be thoroughly grounded in economic fundamentals and in the principles governing the practical operation of every department of a business.

Take, for instance, the case of companies manufacturing agricultural implements. Owing to the character of the manufacturing operations, to the seasonal nature of the business, and to the terms of sale, such companies need to maintain relatively high ratios of current assets to current liabilities. It may take several months to convert raw materials into finished products, several more to dispose of the finished products, and then additional time to realize cash from sales—due to the long

credit terms on which agricultural implements are sold to dealers. Thus the average current ratio of a number of well-managed companies in this field has been found to be nearly 5 to 1.

Comparatively high current ratios are also found in other lines of business similar to that of agricultural-implement manufacturing, such as clay products; bituminous-coal mining; copper mining, smelting, and manufacturing; electrical machinery; explosives; and leather. On the other hand, relatively lower current ratios are found in lines of business where the process of manufacturing is rapid, where stocks are turned over rapidly, and where terms of sale are short, such as cereal manufacture, flour and grist mill products, canning and preserving food products, and most trading concerns.

The Current Ratio and Business Conditions. The general trend of business conditions also affects the current or working-capital ratio. In a period of business expansion, sales usually increase both in volume and (due to rising prices) in dollars. This increase usually results in larger inventories and greater amounts outstanding in notes and accounts receivable. If current liabilities increase equally, the working-capital ratio declines. This gives an automatic check-up on the need for greater working capital—which may be provided from various sources, such as earnings turned back into the business, additional capital contributions, by a more rapid stock or inventory turnover, or by the liquidation of some of the fixed assets.

On the other hand, in a period of business depression, a decline in sales volume may be attended by a reduction in inventories and receivables. If current liabilities are correspondingly reduced, the current or working-capital ratio will be increased. It is therefore the aim of good management to maintain a satisfactory amount of net working capital by reducing inventories and by effecting close collection of maturing notes and accounts payable so that current obligations may in turn be liquidated.

The keen investigator of financial statements observes all increases or decreases in the working-capital ratio and, if possible, determines their causes.

He does not consider any one factor independently. For example, he does not ascribe a decline in this ratio to general business conditions, to slow collections, or to reduced turnover, until he has investigated all the factors. Otherwise he might overlook some very important causes, such as the withdrawal of a large amount of working capital for investment in permanent improvements or the payment of a long-term debt.

Estimating the Normal Working-Capital Ratio. In estimating the normal current or working-capital ratio for any business during any one period of time—"normal" meaning the one ratio that indicates the right amount of working capital under current conditions both within the business and within the industry as a whole, as well as under general business conditions—efficient financial management seeks to study the records of past years, and to analyze conditions (both inside and outside the business) in their relations to these records; then to arrive at its estimate after carefully judging *all* important influencing factors. The resulting figure, commonly called the "normal current ratio," may then serve as a guide to future studies and analyses.

A fluctuation over or below this normal figure indicates to the careful observer definite trends in the current financial condition of the business.

What Changes in the Current Ratio Indicate. The significance of changes in the current or working-capital ratio may be summarized as follows:

1. Downward movements are indications of less favorable working-capital position, and of greater difficulty in meeting outstanding current indebtedness with proceeds from current assets.
2. Upward movements are indications of a stronger working-capital position, and a greater ability to meet outstanding current indebtedness.

The establishment of a normal current ratio enables the management to make valuable comparisons between its own working-capital position and that of other businesses of a like nature, as well as to determine its degree of strength or weakness in meeting its current obligations at any period of time, its need for borrowed funds, for closer collections, etc.

Practical Use of This Ratio. The practical use of the working-capital ratio can be illustrated best by studying the financial condition of a representative manufacturing concern.

On December 31, 1924, the current assets of the A. & B. Manufacturing Co. stood at \$3,851,000, in round figures; current liabilities at \$1,192,000. This is in the ratio of 3,851 to 1,192, or approximately 3.2 to 1. In 1925 the current assets stood at \$5,183,000; current liabilities at \$2,064,000, or in the ratio of 2.5 to 1. Thus, while current assets and current liabilities both increased between 1924 and 1925, the ratio declined by seven-tenths, or the difference between 3.2 and 2.5.

Now, if we were to consider only the change in net working capital (the difference between current assets and current liabilities), we would get only an incomplete picture, for net working capital showed an increase of \$460,000 over 1924. (It was \$2,659,000 in 1924, and \$3,119,000 in 1925.)

Thus, since the working-capital ratio has declined, even tho net working capital has increased in amount, we have an indication that the trend from 1924 to 1925 shows a slight weakening in borrowing power. This brings up the important consideration that—

The trend of the working-capital ratio indicates the development or recession of a firm's borrowing power.

As we have already seen in our study of financing, and as we shall see later in our study of credits and collections, a prospective lender of money or credit considers

the ability of the borrower to meet outstanding obligations from proceeds realized on current assets as an important factor in extending credit.

The Ratio of Debt to Net Worth. When a new business is started, the original owners contribute money, property, services, patents, and the like, for use in carrying on the business. These contributions may be termed "owned capital" or "original investment."

In operating the business, the owners nearly always require outside (borrowed) capital or credit with which to make permanent improvements and additions; also to buy supplies, to meet expenditures, and otherwise to provide adequate facilities and working capital for carrying on the business. Especially is outside or borrowed money and credit likely to be required as the business expands. The securing of this capital from the outside may take the form of bond and note issues, credit extended by suppliers, bank loans, etc., as covered in preceding executive manuals. The total of all outside borrowed capital represents the "debt" part of the ratio of debt to net worth.

The total capital of the business, together with surplus earned and undivided profits, enters into the second element in this ratio—"net worth," which, as defined in Part I of this executive manual, is the excess of the total assets over the total liabilities.

Whenever a business is using borrowed capital, there are two classes of those who have equities or ownership rights in the business. One is the owners of the business and the other class is the creditors who have loaned money or credit to the business.

Ordinarily, the lower the ratio of debt to net worth, the healthier is the financial condition of the business, and the more attractive is the business to lenders of money or credit.

It is plain that the owners of a business should have a larger equity in the business than the creditors. Bor-

rowed capital carries certain fixed charges that must be paid in good years as well as in bad; while owned capital carries no such obligation. A change in the ratio of debt to net worth, whether down or up, may be either favorable or unfavorable—depending upon the cause of the change. If an increase in debt results in acquiring certain additional assets which serve to make the business more profitable, the higher ratio of debt to net worth may be favorable in the eyes of prospective creditors.

Some of the large, well-managed railroad and public-utility companies, where large sums are needed for long periods of time for investment in costly fixed assets, such as trackage, power plants, and other equipment, often find it best, even tho not entirely necessary, to finance the purchase or construction of such assets by obtaining large long-time loans at reasonable rates of interest, and by giving as security a mortgage on the property. As long as the fixed charges, such as interest and perhaps payments into a sinking fund, on such a long-term obligation (usually termed "funded debt") are earned several times over in operating the business, a relatively high ratio of debt to net worth may not be a danger signal.

In using the ratio of debt to net worth as a means of estimating the degree of financial soundness of a business, the causes and effects of the debt must be considered.

Ratio of Net Worth to Fixed Assets. The first element in this ratio—net worth—has been defined above as the excess of total assets over total liabilities to creditors. Fixed assets—the second element—are also called "capital assets," since they usually are, or should be, created out of the capital advanced by the owners or obtained thru long-term borrowing. Fixed assets include land, buildings, machinery, equipment, and any other assets of a fixed nature as contrasted with current assets which are currently converted into cash or its equivalent.

It is not in accordance with sound management prin-

ciples to finance the acquisition of fixed assets with any part of the working capital that has been obtained thru current borrowing. This was demonstrated by the experience of the Harmon Battery Company as described in Executive Problem 7 of this training service. That company put much of its borrowed capital into fixed assets, and was therefore unable to borrow further to meet its current obligations.

A safe plan for a business to follow is always to acquire fixed assets from funds provided by the owners or obtained from long-term borrowing.

If the ratio of net worth to fixed assets shows a rapid decrease, we may be reasonably safe in assuming that the management has distributed too much of its net earnings in dividends to the owners, or has increased its fixed assets too fast, perhaps by too heavy an investment in land or too rapid an expansion in plant and equipment.

If expansion calls for additional fixed assets, it is seldom justifiable to pay for these at the expense of a drain upon the liquid working capital.

Altho usually the financing of plant expansion is most satisfactorily done by means of long-time borrowing, it is usually wise, where plant expansion can be anticipated far enough ahead and current earnings are large enough, to build up a substantial surplus from earnings for this use.

A marked decline in the ratio of net worth to fixed assets, however, may not be unfavorable—if an addition of fixed assets gives the business a decided increase of earning capacity. A steady increase in this ratio indicates that net earnings are being used to reinforce the working capital or liquid assets of the business and are not being all paid out as dividends or invested in fixed assets.

INCOME AND BALANCE-SHEET COMPARISONS

The three ratios which we have considered thus far were comparisons of items that appear in the balance

sheet. We are now ready to consider four other important ratios which bring into play certain items that appear in the income or profit and loss statement as compared with items from the balance sheet. They provide further means of analyzing the financial condition of a business; and this further analyzing will enable us to apply sound principles in checking up on collections, the rate of stock turnover, the productiveness of fixed assets, and the earning power of owned capital.

In setting up these ratios we find that one element in each is an item in the balance sheet, and the other an item in the income statement. In using them we secure tests of the operating efficiency of a business. The balance-sheet ratios previously explained are like the examination which a physician makes of a man's present physical condition. But just as a physician supplements the physical examination by knowledge of the patient's activities over a period of time, so the thoro investigator of a firm's financial condition studies the items on a balance sheet in relation to the current operating activities of the firm as shown by the income statement.

Sales are usually thought of as the lifeblood of a business, and they are; therefore it is desirable to study the relationship of sales to certain important elements such as receivables, inventories, and fixed assets.

The Ratio of Sales to Receivables. Relatively few business concerns to-day obtain cash from all sales made. It is important, therefore, that the owners of a business know pretty definitely what percentage of sales are made on credit and how long a time elapses, on the average, between sales on credit and collections on these sales.

Most balance sheets do not show the relative amounts of cash sales and credit sales. Nevertheless, the owners of a business should have definite figures on the amount of credit sales, so that they may compare this amount with the average amount of receivables outstanding as a

result of sales on credit. Such a comparison gives a check on the effectiveness with which collections are maintained.

By calculating the average daily amount of credit sales (say, \$1,000), and by dividing this amount into the average sum of receivables outstanding (say, \$40,000), we get a quotient (40) which represents the average number of days in which receivables are outstanding. If we compare this figure with the terms on which credit sales are made, we get a check on the efficiency of our collections. If the terms are 30 days net and it takes 40 days, on the average, to make collections, the excess of days required to collect measures the efficiency (or inefficiency) of collections.

As to the importance of the ratio of sales to receivables—the rapidity with which receivables are “turned over” during the year in relation to sales—we know that it costs a firm money to have receivables outstanding. Working capital has to be provided from other sources; the more quickly receivables can be turned into cash, the more readily discounts can be taken on goods purchased, and notes and accounts payable reduced.

Comparisons of the sales-to-receivables ratio over a period of years will help to indicate the relative effectiveness with which a firm's working capital is being used.

If a business is doing an annual sales volume of \$720,000 (\$2,000 a day), and the average receivables outstanding amount to \$100,000, the receivables are outstanding for 50 days, on the average. If collections are speeded up so that receivables are outstanding for 45 days, on the average, in relation to sales, the average receivables are reduced \$10,000 (5 days' sales at \$2,000 a day). If this sum is applied to reduction of current liabilities, it will mean a saving on borrowed capital, figured at 7 per cent, of \$700 a year. Not only is this a saving on the cost of borrowed capital, but the current

or working capital ratio goes up, placing the business in better financial condition.

An improvement in the collection of receivables reacts directly to the profit of the owners of a business.

Business Conditions and Terms of Sale. The ratio of sales to receivables is directly affected by terms of sale and general business conditions. Consequently, no one best ratio can be set up for all lines of business, or for any one business for all years. The effect of terms of sale is readily apparent. A business granting only 30 days' credit should naturally have a higher turnover of receivables than a business selling on the installment plan where receivables may be outstanding for several months or even a year or longer.

For the individual concern, or for a particular trade, the trend of this ratio from year to year should be considered in the light of the general business trend. Thus, as we saw in our study of economic factors early in this training service, a period of expansion is a period of rising trade activity, with increasing sales, rising prices, favorable credit facilities, and good collections. Under such conditions the sales-to-receivables ratio should normally tend to rise. With deflation comes sales resistance, tighter credit, and slower collections, so that this ratio then tends to decline.

A close watch should be kept on the ratio of sales to receivables, because a decline may indicate the need of more working capital, and often comes at a time when credit is harder to secure and more costly.

The Ratio of Sales to Inventories. The primary purpose of the ratio of sales to inventories is to give a means of determining the number of times the average stock inventory is turned over during a certain period, usually a year.

To calculate this ratio correctly, the same basis must be used both for sales and inventories. This basis may be either cost or selling price. Usually cost is taken as

the basis. Dividing the cost of goods sold by the average inventory at cost prices gives the rate of turnover of inventories. For example, if sales for the year amount to \$100,000 and the cost of the goods sold is \$70,000, and if the average inventory, at cost price, is \$17,500, the rate of turnover is 4 and the ratio of sales to inventory is 4 to 1.

It is the usual policy of sound management to carry only the minimum amount of stock necessary to meet the needs of the business, altho this policy is flexible to allow advantage of favorable buying conditions to be taken.

The profit gained by acquiring more than the requisite amount of inventories on a low market must be greater than the cost of providing the additional working capital thereby required.

Since there is usually no way of insuring this excess of profit over the increased cost of providing additional capital, a firm which makes a practice of trying to anticipate rising prices on a greater-than-necessary inventory is plainly speculating. It is betting on its judgment of future price trends. The safest practice is to eliminate speculation by the purchase of only such stocks as are necessary to provide for current operating needs.

In judging inventory turnovers in outside concerns it is seldom possible to learn, or to estimate accurately from published reports, the cost of goods sold. In such cases approximate estimates can be made for purposes of determining yearly trends by comparing net sales to inventories and expressing the ratio in terms of dollars of net sales to \$1 of inventories. Thus, if a business reports sales for one year at \$330,000 and inventories at \$100,000, the ratio would be expressed \$3.3 to \$1. If sales for the preceding year were \$440,000 and inventories were \$110,000, the ratio would be stated as \$4 to \$1. A comparison of the ratios for the two years indicates in a rough way the trend of inventory turnover from \$4 to \$1, to \$3.3 to \$1. But that method of calculation has

the disadvantage of omitting consideration of gross profit, which is an important factor; for, if this margin were greater in the first year than in the second, the reduction in stock turnover was not so marked as the above comparison indicates.

This factor of gross profit is of particular importance in comparing the inventory turnovers of concerns in different lines of business, because margins of gross profit, as a rule, vary widely between different lines of business.

Ratios of sales to inventories can be safely compared only when allowance is made for any differences in gross-profit margins by years, firms, and lines of business.

The rule of comparing sales at cost with inventories at cost prices, previously emphasized, is therefore of considerable importance.

Inventory Turnover and Net Profits. In using all financial ratios, management is most concerned with what they indicate concerning net profits.

If a firm carries average inventories of \$40,000 and its annual sales amount to \$120,000, both figured on the cost basis, it is securing a yearly turnover of 3, or its ratio of sales to inventories is 3 to 1. Then, if it can increase this ratio to 4 to 1, still having the same amount of sales (\$120,000 at cost prices), its inventory is reduced by \$10,000 (to \$30,000). If its net worth is \$56,000, the increased earnings to the owners—effected by speeding up turnover of inventories—may be readily calculated, unless there were a downward or upward trend of costs of goods carried in stock. If not, the saving in interest, at 7 per cent, on the reduction of \$10,000 in working capital, or \$700, would mean $1\frac{1}{4}$ per cent additional net profits earned on the net worth.

As a rule, it may be said that—

An increase in the ratio of sales to inventories, if sales hold up, means an increase in net profit.

The trend of inventory turnovers should be studied, not only in its relation to activities within a particular concern, but also in its connection with the moving trend of general business conditions. In periods of expansion stocks on hand can usually be more quickly moved than in periods of contraction or depression. Expansion or recession in sales—as influenced by general business conditions—should be closely watched, so that stocks may be built up and replenished satisfactorily during times of increasing activity and rising prices, and reduced to the required minimum during periods of lessening activity and falling prices.

The Ratio of Sales to Fixed Assets. As previously explained, fixed assets represent a permanent investment of owned or borrowed capital. It is important in every business that the volume of sales be great enough to provide for a satisfactory return on the money invested in fixed assets.

Fixed assets are subject to certain fixed charges which must be met year in and year out: taxes, insurance, repairs, depreciation, and—where fixed assets are financed in part out of long-term borrowed capital—interest and sinking-fund payments. The relative productiveness of fixed assets is therefore of direct concern to the owners of a business. Sales must be large enough to employ fixed assets to an extent that yields gross profits sufficient to meet the charges on fixed assets, to pay current operating expenses, and to leave a satisfactory portion as net profits to the owners.

We have already seen how management can make adjustments of inventories and receivables to meet changing conditions. Not so with fixed assets, for they are not readily salable and are not worth their full value except as an integral part of the going business enterprise. Just as they cannot be readily liquidated, and usually only at a loss, so they cannot be increased with-

out some delay and without provision for the tying up of owned or borrowed capital over a considerable period. It is evident therefore that the ratio of sales to fixed assets has a direct bearing on the net profits which a business can earn.

This ratio is usually expressed as so many dollars of sales to each dollar invested in fixed assets. Thus, if a firm's annual net sales are \$750,000, and the value of its fixed assets is \$500,000, the ratio is 1.5 to 1. If, in the next succeeding year, sales increase to \$900,000, while the value of fixed assets remains unchanged, the ratio is, of course, increased accordingly, and this would indicate that the productiveness of fixed assets has been increased, leaving more per dollar of sales to meet working-capital requirements and to provide net profits.

A change in the ratio of sales to fixed assets indicates a similar, tho not necessarily a proportional, change in the productivity of fixed assets—also, usually, a corresponding change in cost per unit of product sold and in net profits.

However, an important factor which must not be overlooked is the effect of fluctuating prices. Over a period of rising prices, increased sales in dollars do not mean a corresponding increase in volume of units sold; and unless the amount of profit per unit is greater in direct proportion to the rise in prices, a comparison of this ratio with those of other years may be misleading as an indicator of improvement; also, of course, unless the number of products sold is greater, this ratio may suggest a misleading comparison of the productivity of fixed assets as between the two periods.

Many careful analysts prefer to show the ratio of sales to fixed assets in terms of units sold, instead of dollars; or they may adjust the sales totals in dollars to the price difference as between the two periods. Either of these methods makes possible a more accurate analysis of the trend of the ratio from year to year, and therefore gives

a more accurate indication of the effects of the trend on the net profits.

Variations by Lines of Business. The ratio of sales to fixed assets varies considerably for different lines of business. In some lines a relatively large portion of owned and borrowed capital is invested in fixed assets; in others, only a small portion. Such industries as bituminous-coal mining, iron and steel manufacturing, and copper mining and manufacturing, require large percentages of the total capital employed to be invested in fixed assets. For such lines the ratio of sales to fixed assets holds greater significance than for industries that have relatively small percentages tied up in land, buildings, and equipment, such as boot and shoe manufacturing, electrical-machinery manufacturing, and general merchandising.

Another cause for variation in the significance of this ratio by lines of business lies in a difference in margins of gross profits. Competitive conditions within a particular industry regulate fairly evenly the margin of gross profits for firms in that industry. Where the margin of gross profits is rather narrow and where a large percentage of total capital employed is invested in fixed assets, it is apparent that sales must be maintained at a satisfactory ratio to fixed assets in order to prevent net profits from being quite adversely affected.

Since competitive conditions within an industry offer such a strong curb to increases in gross-profit margins, there are usually but two ways left open for the owners of a business to improve an unsatisfactory ratio of sales to fixed assets: either to increase sales volume or to pare down fixed assets. The first course is difficult to pursue in a strong competitive market; the second involves the taking of considerable losses. Therefore,

The expansion of fixed assets to meet the apparently growing needs of a business should be carefully considered with regard to the past and present trends of the sales-to-fixed-assets ratio (and to the future trend

as affected by contemplated expansion) and to the movements of the business cycle.

A firm that greatly enlarges its property and plant facilities during a period of expansion often finds the additional fixed charges too heavy a burden to carry when business declines. As we saw in Executive Manual 3, a period of declining activity usually means heightened competition, greater sales resistance, and smaller margins of gross profit.

The careful consideration of the trend of the sales-to-fixed-assets ratio is an important factor in checking overexpansion which cripples so many business firms.

Net Income to Net Worth. After all is said and done, the acid test by which the owners of a business judge their undertaking is the percentage of net earnings to the owned capital. Owned capital, or net worth, we have already defined as the difference between the value of total assets and the value of total liabilities. Changes in the ratio of net income to net worth measures changes in the true profitability of a business from period to period.

Just as the manager of a major-league baseball team sizes up the strength and weakness of his players individually and collectively by means of pitching records, batting and fielding averages, runs scored per game, etc., a business manager sizes up the strength and weakness of the various departments and operations of his business by the analysis of financial statements. But just as baseball averages are not an end in themselves, so the trends of financial ratios do not in themselves tell the complete story. The accomplishments of a baseball team are judged by the number of games it has won and lost. And—

The measure of the success of a business enterprise is the net profits it earns figured as a percentage on net worth.

The methods used in arriving at the final figures of net income have been indicated in Part I of this executive manual. The methods used in computing net worth were also explained. If the ratio of net income to net worth shows a relatively steady gain year after year, this is good evidence of the efficiency of the management—unless net worth has been too greatly reduced by changes in the ratio of current assets to current liabilities or in the ratio of net worth to fixed assets, or in both.

Thus, while the ratio of net income to net worth truly expresses the profitableness of a business for any period, changes in this ratio, as in all other ratios, must be interpreted in the light of all influencing factors. That is why more than this one ratio is desirable in analyzing the progress of a business. We must get at the causes of changes in ratios, by checking changes in one ratio against changes in others and by analyzing various items on the balance sheet, by comparing these items one with another, and with certain items shown on the income statement. The ratios explained in preceding pages play a prominent part in this analyzing and comparing process. They are the more or less standardized ratios that may be used in almost any business, but they are by no means all the ratios (comparisons) that may be useful in determining the financial trend of progress in every business.

Different kinds of financial comparisons are found to be useful in different kinds of businesses; and it is a prime function of financial management to find out what are the most useful comparisons of balance-sheet and income-statement items for the particular business.

These comparisons are the means of formulating the financial policies and many of the operating policies of a business; and these policies are closely linked with, and influenced by, the daily financing procedure, which procedure we shall analyze in the next executive manual.

CHECK-UP ON PRINCIPLES

Use the following check-up to get the principles of this manual firmly fixed in mind. This will help you to handle the problem which follows. This check-up is entirely for your own personal use, so you need not send it in to the University.

	Check	
	Yes	No
1. In the spring of 1922, W. B. Caldwell started a small woodworking plant in a town about 15 miles distant by rail from a prosperous manufacturing center of some 75,000 people. His means were limited, and he was able to get only a small line of credit from the local bank. But he knew his business, and he knew how to develop his market. He looked forward to the time when he would have a flourishing business many times larger. Would there be any object in his sending quarterly financial statements to one of the large banks in the neighboring city, even tho he did not expect to need a large line of credit for several years?		
2. The balance sheet of the Corbin Company, manufacturers of paints and varnishes, shows total assets of \$65,000. Goodwill is valued at \$5,000; patents and formulas at \$10,000; deferred charges are negligible. Capital stock is listed at \$20,000; surplus at \$12,500. Is the interest of the creditors in the realizable assets (current and fixed) of the company greater than that of the owners?		
3. Retail dry goods stores usually make purchases on open account. In the financial statement of the Walker Dry Goods Co., accounts payable are listed at \$2,500, about 5 per cent of total yearly purchases. Notes payable, as shown on the statement, amount to \$20,000. Would you consider it necessary to know to whom these notes are owed?		
4. Will a thoro analysis of a properly prepared balance sheet give you a clear and complete picture of the company's financial condition?		
5. Capone & Gorci, commission merchants, want to borrow several thousand dollars to finance an incoming shipment of grapes. Their banker consents to grant a 30-day loan, but insists that Capone & Gorci deposit acceptable collateral. Does this indicate a poor credit standing?		

	Check	
	Yes	No
6. The annual statements of the Moline Plow Company, for the four years, 1917-1920, inclusive showed current ratios less than 4 to 1. The average for the four years was 2.74 to 1. Would this indicate to you an unfavorable condition?		
7. A well-known company engaged in the production of chicle and the manufacture of chewing gum reported current ratios as follows: 1918, 5.82 to 1; 1919, 4.57 to 1; 1920, 2.43 to 1; 1921, 1.09 to 1; 1922, 1.18 to 1. Is it likely that general business conditions may have had some influence on the trend of this ratio? Do you think it likely that the company found it more difficult to borrow in 1921 than in 1918 and 1919?		
8. Company S manufactures baby carriages, wheel goods, etc. Here are the ratios of sales to receivables, taken from the published annual reports of recent years: 1919, 10.4 to 1; 1920, 8.3 to 1; 1921, 5.7 to 1; 1922, 5.8 to 1; 1923, 5.2 to 1. Do these figures indicate increasing effectiveness in the use of the firm's working capital?		
9. As shown by its annual statements, the ratio of sales to inventories of the Bridwell Candy Co. for the years 1922, 1923, 1924 ran as follows: 4.6 to 1; 5.3 to 1; 6.2 to 1. Sales increased moderately. Is it probable that net profits increased over this period?		
10. The K. Steel Company has 70 per cent of its total assets represented in fixed property investments. Is it important for the management to keep a close watch on the ratio, sales to fixed assets?		
11. Can a mail order house, with current assets approximately 60 per cent of its total assets, better withstand a decline in sales volume than the K. Steel Company?		

Executive Problem 44

DIAGNOSING BUSINESS ILLS

By Using Financial Ratios
UNDER THE LASALLE PROBLEM METHOD



SIXTEEN to One, the ratio Mr. Bryan made famous in the campaign of 1896, is well known to everyone to-day, while the statistics that that ratio represents are forgotten. Why? Because ratios are more meaningful than figures. The mind can grasp the significance of a ratio far more easily than it can compare long numbers. That is why financial statements are interpreted thru the ratios that can be worked out from them. These ratios will then point out the weaknesses and strength of the business.



Prepared by the Research and Consultation Staff of LaSalle Extension University from an interesting problem which it has carefully investigated and analyzed.

Executive Problem 44

DIAGNOSING BUSINESS ILLS

The LaSalle Consultation Staff frequently receives requests for help on financing problems. One of the rather recent requests presented the details of a situation of such general interest that it is given here just as it was sent in—except, of course, that names, addresses, and the exact nature of the business have been changed.

Our inquiry gave us the following data:

The Moseley Furniture Company was located in a small but flourishing manufacturing center of the Middle West. The firm sold furniture on the installment plan, and had practically a monopoly in that business in that community, for the two other large furniture houses sold for cash or on short open-account terms. The business was incorporated for \$100,000. Up to the end of 1923 but \$60,000 had been paid in, and that amount of stock had been issued. Mr. Moseley held \$48,000 of this, and his son-in-law, Charles Mace, held the remainder—\$12,000. Mace supervised the bookkeeping, collections, and business details, while Moseley did the buying and supervised the selling.

The latter desired to retire. Both he and Mace thought highly of a wholesale furniture salesman, Harry Phelps, who had suggested that he would like to buy an interest in the business. After some negotiations, Moseley sold his stock to Mace and Phelps for \$60,000, of which \$7,500 was to be paid April 30, 1924, and \$7,500 on the 15th of each succeeding January until payment in full had been made.

The new owners returned the certificate for this \$48,000 in stock to Mr. Moseley to be held as collateral on the notes they had given him.

Mr. Moseley remained in charge of sales until April 30, 1924, when Mr. Phelps took charge of the buying and

Comparison of Balance Sheets

ASSETS

	12-31-23
Cash on hand and in banks.....	\$ 13,421.16
Accounts receivable	73,462.12
Inc. above .....	.....
Notes receivable	3,972.63
Merchandise inventory at cost.....	34,257.48

Total Current Assets.....	\$125,034.39
Fixed Assets: Fixtures, trucks, etc., less depreciation.....	8,876.67
Goodwill, including value of lease.....	.....
Deferred charges .....	.....

Total Assets\$133,911.06

LIABILITIES AND CAPITAL

Accounts payable not yet due	\$ 6,214.47
Accounts payable overdue .....	.....
Notes payable for merchandise, due within 30 days.....	.....
Notes payable for merchandise, due within 60 days.....	4,400.00
Notes payable for merchandise, due within 90 days.....	.....
Notes payable to banks	24,000.00
Notes payable to individuals	8,000.00
Accrued wages and expense.....	.....

Total Current Liabilities.....	\$ 42,614.47
Capital stock outstanding.....	60,000.00
Reserve for bad debts.....	889.48
Surplus, accumulated	30,407.11
Profit for period less dividend paid.....	Inc. above

Total Liabilities and Capital.....	\$133,911.06
Contingent liability on notes discounted.....	.....

12-31-24	4-30-25
\$ 7,231.21	\$ 1,973.90
88,790.10	93,676.75
10,000.00	Inc. above
4,547.28	2,923.37
65,276.42	79,820.51

\$175,845.01	\$178,394.53
7,988.31	8,043.59
10,000.00	10,000.00
.....	185.00

Total Assets\$193,833.32

\$ 9,845.57	\$ 5,660.71
8,797.49	10,052.07
3,421.00	8,137.74
5,355.56	6,053.15
3,725.00	7,815.41
40,000.00	41,500.00
4,000.00	4,200.00
.....	286.14

\$ 75,144.62	\$ 83,705.22
100,000.00	100,000.00
764.97	.....
407.11	10,016.62
17,516.62	2,901.28

\$193,833.32	\$196,623.12
1,202.00	3,083.93

Comparison of Income Statements

	Year Ending 12-31-24	8 Months Ending 12-31-24	4 Months Ending 4-30-25
Sales (net)	\$188,920.21	\$144,850.72	\$ 49,748.55
Cost of goods sold.....	111,691.77	94,618.79	31,049.13
Gross profits on sales.....	\$ 77,228.44	\$ 50,231.93	\$ 18,699.42
Deduct expenses:			
Selling expense	31,613.47	22,585.16	9,585.68
Accounting and collection expense.....	8,154.25	5,291.88	2,534.16
Administrative and general expense.....	9,367.61	5,286.23	2,713.22
	\$ 49,135.33	\$ 33,163.27	\$ 14,833.06
Net profit on sales.....	\$ 28,093.11	\$ 17,068.66	\$ 3,866.36
Add for interest earned	960.98	589.03	283.83
Add for purchase discounts taken	2,501.55	1,072.68	225.79
	\$ 31,555.64	\$ 18,730.37	\$ 4,375.98
Deduct for interest paid.....	4,124.80	2,885.89	1,474.70
	\$ 27,430.84	\$ 15,844.48	\$ 2,901.28
Deduct for bad debts.....	2,414.22	1,864.97	.....
Net income for period.....	\$ 25,016.62	\$ 13,979.51	\$ 2,901.28
Dividends paid out of the above earnings on 4-30-24 and 1-3-25.....	15,000.00	7,500.00	.....
Net balance to surplus.....	\$ 10,016.62	\$ 6,479.51	\$ 2,901.28

selling. Just previous to that date the new owners added \$10,000 to the surplus account by appraising the value of the firm's goodwill and leases at that figure. They then declared a stock dividend of \$40,000 to themselves, thus bringing issued capital stock up to \$100,000 and decreasing surplus to a nominal amount. Next they declared a $7\frac{1}{2}$ per cent dividend, and thus took out of the business the \$7,500 needed to make the first payment to Mr. Moseley. He was not pleased with this procedure, and regarded it as sharp practice.

Under the new management the volume of sales remained good. The income and expense statement for the year 1923 showed a good profit, so the owners declared another \$7,500 dividend out of this profit, with which they paid Mr. Moseley the \$7,500 due him in January.

Mr. Mace found, however, that he was having more and more trouble with finances. Where formerly the company had discounted most of its bills, now bills were overdue, and bank loans had reached the limit of the company's line of credit. Notes received from certain customers, such as hotels which bought in wholesale quantities, had been discounted, but even this had not helped much.

A year after the new management had taken hold, the bookkeeper, a LaSalle student, received Mr. Mace's permission to refer their problem to us. The accompanying financial statements were sent us also.

The only comments the bookkeeper made were that business conditions in the community were normal, and that in order to stimulate sales, the new sales manager had given the clerks some leeway in quoting prices.

The working papers suggest how such financial statements should be analyzed so as to disclose the strong and weak spots in the financial condition. The ratios which you have studied in this executive manual will prove very useful in interpreting these statements.

In studying Executive Manual 45, which deals with day-to-day financing, keep this problem in mind, for Executive Problem 45 deals with ways of bettering the financial situation of this furniture company.

The executive report you will receive after having sent in your solution of Executive Problem 45 will give you the analysis of this sick business which was made by the LaSalle Consultation Staff, and its suggestions for curing it.

